TAX TREATIES

HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

ON

VARIOUS TAX TREATIES

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TAX TREATIES

THURSDAY, SEPTEMBER 24, 1981

United States Senate,
Committee on Foreign Relations,
Washington, D.C.

The committee met, pursuant to notice, at 10:07 a.m., in room 4221, Dirksen Senate Office Building, Hon. Charles H. Percy (chairman of the committee) presiding.

Present: Senator Percy.

The **Chairman**. The hearing will come to order.

Let me say this to the guards outside the door: In view of the fact that we have so many empty press seats and so many people in the hall and there are so many empty seats reserved for people who are not here, why do we not just let the public come in and fill up the available seats.

[Pause.]

The **Chairman**. I think we have everyone in the room that we can comfortably accommodate.

OPENING STATEMENT

Today, the committee will be considering a number of bilateral tax treaties. The purpose of these agreements is to limit the double taxation of income from international trade and investment, to provide a framework for an exchange of tax information between the treaty partners and to create a mechanism for the resolution of disputes.

This morning, we will be hearing testimony on the tax treaty with Canada. This agreement will replace an existing treaty which has been in effect since 1942. The proposed treaty should prove extremely beneficial both to the United States and Canada. The new treaty will permit both countries to deal more effectively and efficiently with the whole range of tax problems growing out of modern business relations.

The United States will benefit from reductions in the Canadian withholding rates on subsidiary dividends and royalties, as well as from a reduction in the Canadian branch profits tax. Because United States investment in Canada is much greater than Canadian investment in the United States, these reductions may result in an annual net revenue gain to the United States of many millions of dollars. The gain represents a benefit in part to the U.S. Treasury and in part to U.S. taxpayers. In addition, the reduction in taxation in the country of source reduces significantly the compliance burdens of individuals.

Taxpayers in both countries will benefit from the new capital gains rules which permit a meshing of the two systems in a way which will avoid double taxation. United States citizens resident in Canada will benefit from special foreign tax credit rules which will prevent double taxation of their U.S. source income.

Taxpayers will be afforded greater protection against discriminatory tax rates under the proposed convention than under the present convention. The United States traditionally has taken a strong position against discrimination in tax matters and the new treaty, while not as strong as we would like, does represent a substantial improvement over the old agreement.

The existing income tax treaty with Canada is nearly 40 years old and does not permit a solution to many problems of modern trade and investment. In general, the new treaty will allow much greater flexibility in handling the vast range of economic relations existing between the United States and Canada.

Our first witness is the Honorable John B. Chapoton, Assistant Secretary of the Treasury for Tax Policy.

Mr. Chapoton, we certainly welcome you this morning and appreciate your being here.

At the request of the Canadian Ambassador, Ambassador Towe, and the Department of State, we have expedited these hearings. I had felt that we would not be able to take up this treaty until we had completed all of the ambassadorial hearings and a few urgent policy matters which the Department considers important. But I do not think business interests should always take second place to politics and political issues.

I had a deep interest in doing this because I do know the impact that this agreement can have on business. I operated under the old agreement in Canada and established Bell & Howell Canada. From its infancy until its present level of maturity, it has been a great company and I think it has been great for both countries.

Tax problems always are a source of annoyance and concern. Early in my career, I worked in Canada and I was up there this summer for 2 weeks of holiday. That was the first time I had ever been in the Canadian Rockies and thoroughly enjoyed it.

Certainly, by reading the Canadian press you become aware of the tensions that exist economically between our two countries. If this is a small step in relieving these tensions, then we certainly want to do so.

This hearing marks the beginning of this committee's efforts to aggressively move forward and do everything it can from a commercial and economic standpoint to improve our relationships with various countries. Senator Mathias will hold hearings this afternoon on other tax treaties. We have a large backlog and we will move through them just as rapidly as we possibly can.

Your statement is a lengthy one, Mr. Chapoton, and I presume, unless we want to be here for the next couple of days, we should put most of it into the record. However, we would be happy to have you summarize it in any way that you like and then go to questioning.

Would you introduce your colleague.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY OF THE TREASURY, TAX POLICY, ACCOMPANIED BY ALAN W. GRANWELL, INTERNATIONAL TAX COUNSEL, DEPARTMENT OF THE TREASURY

Mr. CHAPOTON. Thank you, Mr. Chairman. First let me say that I appreciate the committee holding these hearings. And, having heard your remarks, we certainly concur in them.

I am accompanied this morning by Alan Granwell, an international tax counsel at the Treasury Department. He has a very thorough knowledge of this and the other treaties that the committee is going to consider today.

As you mentioned, I do have a very lengthy statement that we would like to enter into the record, and I will summarize it. My summary will take less than 10 minutes.

The CHAIRMAN. Your full statement will be incorporated in the record following your oral presentation.

Mr. CHAPOTON. Thank you.

I am pleased to have the opportunity to appear before you this morning in support of the income tax treaty with Canada, and we do, of course, urge its prompt approval.

Tax treaties are an important element in the international economic policy of the United States, one of the fundamental objectives of which is to minimize impediments to international flows of capital and technology. Among these impediments are the inconsistent rules of national tax systems and their interaction. For example, when a resident of one country invest or license technology in another country, both the country of source and the country of residence may seek to tax the resulting income. Tax treaties seek to eliminate such potential double taxation and the resultant inhibitions to international capital investment.

In accordance with our usual procedure, we are submitting the Treasury's technical explanation of the Canadian treaty this morning. I would like to point out that, while the explanation of the Canadian treaty was published previously, it is being formally submitted to the committee for the first time this morning.[1]

The explanation of article XXIV, relating to the elimination of double taxation, in the document we are submitting today differs from the explanation as originally published. The Treasury Department will publish in the near future further explanation of the more detailed rules of this article.

Let me turn now to a discussion of the highlights of the Canadian treaty itself. I will not, as I said, try to go through it in any great detail, but I think we can cover the highlights in a fairly brief period of time.

The CHAIRMAN. Secretary Chapoton, I did have a copy of your full statement last night and I have gone through it. How many copies do we have that can be made available?

Mr. CHAPOTON. I believe we have ample copies of the full statement.

The CHAIRMAN. We will make copies of your statement available, then, to as many of our guests who are here today as is possible.

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[1] See appendix, p. 117.

I thought perhaps we would have an empty house today. I thought I was in the wrong hearing room when I saw the size of the crowd today. Have we been able to accommodate everyone? Are there people left in the hall?

There are still a few chairs up front that are available. I simply did not have any idea of the public interest in this subject area.

I wanted to chair the Canadian treaty myself because our closest neighbors certainly ought to be considered first and be put on the front burner. I am delighted at this interest. We will try to accommodate as many people as possible by giving out copies of Secretary Chapoton's full statement. This will cover the detailed technical explanation.

I would like to say that I understood every aspect of it, but I needed Arthur Andersen alongside me last night to help in the interpretation. So your summary now in layman's language will help.

Mr. CHAPOTON. I believe, Mr. Chairman, we will still be examining it for some time to come.

The proposed treaty with Canada replaces the treaty that was signed in 1942, as you mentioned. It is needed to reflect changes in the tax laws and treaty policies of both the United States and Canada since that date. The 1942 treaty does not adequately address the tax treatment of a growing number of transactions with complex double international taxation ramifications.

Because of the variety and number of important business transactions between our two countries, and the important differences between the tax laws of the two countries, the proposed treaty which we are reviewing this morning is more ambitious, more detailed and more complex than any other U.S. tax treaty.

The rates of withholding on many forms of passive income in the proposed treaty are reduced on a reciprocal basis from the general 15 percent rate in the 1942 treaty. United States direct investors receiving dividends from Canadian companies will be taxed by Canada at a rate of 10 percent under the new treaty, the first treaty in which Canada has agreed to a rate below 15 percent. This reduction reflects the fact that Canadian internal law provides a credit to Canadian shareholders of 50 percent of a dividend received from a Canadian company.

The rate of withholding on portfolio dividends and interest remains at 15 percent, as under the present treaty. Under the proposed treaty, a tax at source on royalties from intangibles is reduced from 15 percent to a maximum rate of 10 percent.

Consistent with the United States and OECD [Organization for Economic Cooperation and Development] models, royalties from natural resources are taxable at source, pursuant to each country's laws. Canada will tax such royalties at its statutory rate of 25 percent of the gross royalty and the United States will generally tax such royalties at a rate of 30 percent. In contrast, under the 1942 treaty natural resource royalties are taxable at source at a maximum rate of 15 percent.

Because of the physical proximity of the United States and Canada, the treaty expands the usual source basis tax exemption for income from international shipping and aircraft to also encompass income from certain activities of railroads, lessors of rolling stock and common carriers.

The gains article allows greater source basis taxation than the 1942 treaty, including tax by the situs country of gains derived by a resident of the other country from the alienation of real property.

The proposed treaty also provides on a reciprocal basis that, for example, gain derived by a Canadian resident from the sale of his stock in a company—other than a Canadian company—or from the alienation of an interest in a partnership, trust or estate, is subject to taxation by the United States, if the value of the interest or the shares is derived principally from U.S. real property. However, the foregoing rules are subject to the limitation that the right to tax such gains depends on whether the other country would in comparable circumstances impose a tax on such gains under its domestic law.

Certain provisions in the gains article are designed to deal with differences between Canadian and U.S. law concerning when an alienation of property generates income for tax purposes in order to prevent potential international double taxation. The article also provides a transitional rule reducing the amount of gain subject to taxation where, for example, a resident of Canada alienates certain property which may be taxed in the United States and which was owned by such Canadian on the date of signature of the treaty.

The treaty contains rules similar to those in the 1942 treaty concerning the deductibility of contributions by a resident of the United States or of Canada to a charitable organization in the other country. Such contributions by a U.S. person will be deductible for U.S. tax purposes so long as they do not exceed the percentage limitation of the code as applied to income of the person arising in Canada. The Canadian income limitation does not apply in the case of contributions by a U.S. person to a Canadian college or university at which he or a member of his family is or was enrolled.

The treaty also provides that the income of religious, scientific, literary, educational, or charitable tax exempt organizations of Canada or the United States is exempt from tax by the other country. Also, dividends and interest derived by certain tax exempt pension funds or retirement plans are exempt from tax by the other country under the new treaty.

The proposed treaty provides for a foreign tax credit intended to avoid double taxation. The U.S. foreign tax credit allowed by the treaty applies to specified Canadian taxes imposed with respect to income from Canadian sources, as provided in the treaty.

There are two types of benefits a taxpayer may derive from the treaty tax credit rules: First, because the treaty contains its own source rules, it is possible that a U.S. taxpayer with operations in Canada will be viewed under the treaty as having a greater amount of Canadian source income than he would have had under the rules of the code. Under the treaty this additional Canadian source income may be taken into account by the taxpayer to increase the allowable foreign tax credit in the United States with respect to Canadian taxes.

Second, because the treaty guarantees a U.S. foreign tax credit for specified Canadian taxes, regardless of whether these payments are creditable under the code, a taxpayer might benefit from the treaty by crediting amounts that would otherwise not be creditable for U.S.tax purposes.

The treaty also contains a number of important administrative provisions. It allows the competent authorities of the two countries to settle transfer pricing cases. Thus, for example, if IRS proposes an increase in a person's U.S. tax liability with respect to a non-arm's length transaction with a related person in Canada, the treaty contemplates that if the Canadian authorities agree with the adjustment there will be a corresponding adjustment in Canada to decrease Canadian tax liability.

Canada was not willing to override its statute of limitations generally for this purpose, but the treaty does require an override of the statute of limitations if there is a timely notice of potential tax adjustment from the other country. If the timely notice is not given, the country considering the adjustments must unilaterally reduce the adjustment to the extent necessary to avoid double taxation.

The treaty contains stronger protections against tax discrimination than does the 1942 treaty. It, like the 1942 treaty, protects individuals of the United States and Canada from tax discrimination. It also goes beyond the 1942 treaty by providing corporations with protections against discrimination.

Both countries have agreed that a corporation resident in the United States or Canada, owned by residents of the other country, shall not be subject in the first country to taxation that is more burdensome than that to which similar companies owned by residents of a third country may be subjected. This is third country protection. It is not as broad as the preferred U.S. position on matters of discrimination affecting corporations.

The treaty does not address a form of indirect tax discrimination by Canada which affects U.S. broadcasters. Canada's law, C-58, denies a deduction to any person for the expense of advertising aimed primarily at Canadian audiences and placed in U.S. radio and television stations. While this type of discrimination is not generally the subject of tax treaties, Treasury emphasized in the negotiation of the proposed treaty that Treasury believes C-58 is unfair and an ill-advised use of the Canadian tax system. And I want to emphasize that this administration intends to pursue all available means to convince Canada that it is time to resolve this dispute.

Mr. Chairman, that concludes our summary of the treaty. Once again, we want to urge the committee's prompt approval of the treaty; and again, appreciate very much your prompt holding of these hearings.

[Mr. Chapoton's prepared statement follows:]

PREPARED STATEMENT OF HON. JOHN E. CHAPOTON

Mr. Chairman and Members of the Committee: I am pleased to have the opportunity to appear before your Committee this morning in support of 11 tax treaties which you are considering today. These include nine income tax treaties (with Canada, Jamaica, Argentina, Egypt, Israel, Morocco, the Philippines, Bangladesh and Malta), a protocol to our existing income tax treaty with Norway, and an estate and gift tax treaty with Germany. Though these treaties, with the exception of the protocol to the treaty with Jamaica, were all negotiated and signed by prior Administrations, they have been reviewed by this Administration, and we urge their prompt approval. I wish to thank the Committee for agreeing to our request to delay hearings in the proposed treaties with Denmark, Cyprus and the British Virgin Islands.

We appreciate the willingness of this Committee to hold hearings at this time. Prompt action by this Committee, and by the full Senate, is vital to the U.S. tax treaty program. In the past, the United States has been criticized for delays in the ratification of proposed tax treaties and prospective treaty partners are concerned about the potential for delay. We hope that you agree with us that this is a problem worth resolving.

THE PURPOSE OF TAX TREATIES

Since this is my first appearance before this Committee and it may also be the first opportunity for some members of the Committee to consider tax treaties, I think it may be useful, before discussing particular features of the pending treaties, to review with you briefly the factors which lead to the negotiation of treaties, the general structure and function of income tax treaties, particularly treaties with developed countries, and the specific issues which must be considered in tax treaties with developing countries. I will conclude my testimony with a discussion of estate and gift tax treaties in general and the German estate and gift tax treaty in particular.

The United States has income tax treaties in force with 28 countries, in addition to extensions of our treaties with the United Kingdom, Belguim and the Netherlands to a number of their overseas territories, or former territories which are now independent countries.

The treaties under consideration today include three full or partial renegotiations of existing treaties and seven new treaties. The basis on which decisions are made to enter into a new treaty relationship with a particular country, or to revise or replace an existing treaty, can be summarized as follows:

With respect to initial negotiations, and for the reasons which are outlined below, we seek to have a tax treaty with all of our major trading partners. Our existing treaty network, as well as several of the treaties currently pending, illustrate that we enter into treaties with countries with which we have meaningful economic relations. In addition, for other reasons, described below, we seek to have a tax treaty with jurisdictions that do not constitute major trading partners. This is illustrated by several of the treaties currently pending. Negotiations with these countries may have been initiated for one or more reasons: (1) As our economic relations with a given country expand, we will propose negotiations, especially to reduce tax problems experienced by those American firms which are deriving income from that country. (2) We may have an interest in opening markets in a country, which can be facilitated by the presence of a treaty. (3) We may enter into a treaty with a country, particularly a developing country, in response to both economic and foreign policy considerations, in an effort to promote the economic development of the other country. (4) The impetus for discussions may have come from the other country which perceives a need for a tax treaty with the United States. (5) There may be instances where, because of a prior treaty relationship, possibly through the extension of a U.S. treaty to an overseas territory of our treaty partner, we feel some obligation to maintain a treaty relationship which we might not otherwise initiate.

With respect to renegotiations, if tax treaties become static, they may cease to serve their intended purposes, or do so poorly, as economic conditions, tax systems and the nature of business and commercial relations change. Thus, we frequently find it necessary to renegotiate existing treaties. In fact, we devote a major part of our treaty negotiating resources to the revision or replacement of our existing treaties.

Our present treaty with Canada is illustrative. That treaty was signed in 1942; over time, we found that the treaty was increasingly unable to deal with current problems, and that many types of current transactions and business relationships were not even contemplated in 1942. In addition, major changes in the tax laws of both countries had rendered a number of the existing provisions either unworkable or inappropriate. Thus, it was clear that the treaty required renegotiation. Similar considerations have led to periodic reassessment and renegotiation of a number of our other treaties.

We view tax treaties as an important element in the overall international economic policy of the United States. One of the fundamental objectives of this policy is to minimize impediments to the free international flow of capital and technology. This objective is fostered by the broadest possible network of income tax treaties.

Among the major impediments to free capital and technology flows are the rules of national tax systems and their interaction with the systems of other countries. Tax treaties seek to eliminate, or at least mitigate, the impact of these impediments.

These impediments may arise, for example, when transactions take place between an enterprise in one country and an enterprise in another or when individuals from one country travel for business or cultural purposes to another country. In such cases, taxpayers may find themselves subject to two or more separate taxing jurisdictions. Similarly, the potential for double taxation exists when individuals or corporations of one country invest or license technology in another country, and the countries of source and residence both seek to tax the resulting dividend, interest or royalty income.

THE NATURE OF TAX TREATIES

Due in large part to the work of the Organization for Economic Cooperation and Development (OECD) in developing a Model Income Tax Treaty, the general form and structure of income tax treaties has become largely standardized. The United States first published a model treaty in 1976 which was replaced by a new Model in 1977. A draft revision of the 1977 Model was recently released for public comment and will be finalized after comments have been considered. The 1977 Model, as well as the draft revised Model, follows the pattern of the OECD Model, and forms the starting point for the United States in tax treaty negotiations. This is not to say that all tax treaties are identical. The Model must be adapted, in each case, to reflect the particular policy needs of each country, the economic and commercial relations between the two countries, the need to mesh the provisions of two different tax systems and, finally, the levels of economic development of the two treaty partners.

Despite the inevitable differences among tax treaties, it is possible to describe the general principles and approaches embodied in all tax treaties:

Income tax treaties reduce the prospect of double taxation of international flows of income. In general, with respect to any particular item of income, the country in which the income arises—the source country—is required by the treaty, under specified circumstances, to reduce or eliminate its tax in favor of the tax in the country of residence of the recipient. In return, the country of which the taxpayer is a resident is obligated to relieve double taxation with respect to the tax which is imposed in the source country, by allowing a credit or exempting the income, as the case may be. As under internal law, United States treaties use the credit mechanism. In the normal treaty relationship there are flows of income in both directions. Each country, therefore, will give up tax on income from sources in its country and each country will provide a credit with respect to income of its residents from sources in the other country.

Treaties permit the establishment of common definitions of terms and of rules for allocating income and expenses. They also provide rules for determining a single country of residence for persons subject to the treaty who might otherwise be considered a resident of both countries under their respective internal laws.

With respect to business profits, treaties provide that a resident of one country who engages in business in the other may be taxed by the host country only to the extent that the nonresident's business venture has made a substantial economic penetration into the host country by virtue of having a "permanent establishment" there. Income from international shipping and air transport is normally treated differently from other business profits by providing that only the country of residence of the operator may tax, regardless of whether there is a permanent establishment in the other country.

With respect to personal service income, treaties generally provide that a resident of one country who is temporarily present in the other for the purpose of providing personal services, either in a dependent (employee) or independent (contractor nonemployee) capacity, will not be subject to tax in the host country unless certain threshold tests are met, generally including a specified physical presence there during the taxable year.

Treaties provide for reduced rates of withholding tax at source on investment income (dividends, interest and royalties) by the host country so that the aggregate tax burden on the investor will not exceed that which he would pay if he invested at home. Source country taxation of certain classes of capital gains of nonresidents is also restricted.

Treaties assure non-discriminatory treatment under the tax laws of one country for residents of the other or for corporations of the first country owned by residents of the other. In a tax treaty, nondiscrimination means national treatment. That is, simply stated, the tax burden in one country on a resident of the other should not exceed the burden on its own residents in similar circumstances.

Treaties also authorize consultation and exchange of information between the tax authorities of the two countries both as to matters of tax evasion and to prevent cases of double taxation.

U.S. TAX TREATY POLICY

In addition to the general features of all tax treaties, there are certin particular features which the United States includes in its tax treaties. The most important of these is the so-called "saving clause" under which the United States preserves its full statutory right (with certain necessary exceptions) to tax its residents and its citizens, wherever resident, on their worldwide income, consistent with our internal law.

U.S. tax treaties also include anti-abuse provisions designed to prevent residents of third countries from channeling investments into the United States through the treaty country, thereby deriving treaty benefits to which they are not justifiably entitled. These provisions act to deny treaty benefits (i.e., exemption or reduction of source basis tax in the United States) in such circumstances. Thus, if a resident of a third country establishes a corporation in the treaty country to make his investment in the United States, under appropriate circumstances the anti-abuse provisions would permit the United States to impose its full statutory tax on payments to such a corporation.

It is established U.S. tax treaty policy to include such anti-abuse provisions in tax treaties. The present Model and the draft proposed Model reflect experience gained in negotiating from the 1977 Model. The proposed provision is tighter than that in the 1977 Model though it may well be modified before it is published in final form, on the basis of comments from the public. Even after it is made final I would expect that it will be modified in the course of the negotiation of particular treaties to reflect the U.S. negotiators' perceptions of the potential for abuse in that treaty as well as the needs of the treaty partner. I wish the Committee to understand that this Administration views a tax treaty, in essence, as a contract between two countries designed to benefit directly the residents of those two countries, and not indirectly residents of third countries. Anti-abuse provisions, therefore, will be employed wherever necessary, and in the form appropriate to the circumstances, to assure that U.S. treaties extend U.S. tax benefits consistent with this overall policy.

The United States also now preserves in our new treaties the statutory right granted by Congress last year to tax gains of a resident of the treaty partner on the disposition of real property in the United States and of shares in a U.S. corporation which holds U.S. property. The treaties before you today (with the exception of the treaty with the Philippines) contain provisions that reflect, in part, the new Internal Revenue Code (Code) sections. However, certain of the new Code provisions, such as those contained in section 897(i), provide the exclusive remedy for nondiscrimination, and thereby prevail over these proposed treaties in that regard.

United States treaties also provide, as do treaties of many other countries, that a treaty cannot serve to deny benefits to a taxpayer which are available under the internal law. Thus, for example, if a treaty provides that an item of income may be taxed by the United States, the United States can exercise that right only if, and to the extent that, the taxing right is also provided for in the Code.

REVENUE EFFECT

In addition to focusing on matters of double taxation, tax policy and tax administration, U.S. negotiators also consider the revenue impact of tax treaties. Tax treaties have two basic and offsetting effects on U.S. (and foreign) tax revenues. Each country reduces its tax on income from sources in that country derived by residents of the other. This generates a revenue loss. With respect to income of its residents from sources in the other country, the first country is obligated to credit the taxes of the other. Where the United States is the residence country, this in general merely confirms the credit already provides for by the Code. Thus, the commitment by the United States to grant a credit does not in the normal case, result in a revenue loss. To the contrary, because of reductions by the other country in source basis taxation of the income of U.S. residents, foreign tax credits will be reduced and U.S. revenues will generally increase. The net revenue effect will, of course, depend on the relative magnitudes of these opposite effects.

Where, as is frequently the case, the United States is a net capital exporter in a particular bilateral relationship, the flow of investment income back to the United States can generally be expected to exceed the flow of income payments to the other country from the United States. Since reductions in tax at source are generally reciprocal, the U.S. revenue gain from reduced foreign tax credits resulting from reductions in source basis tax in the other country can be expected to exceed the U.S. revenue loss from reductions in U.S. source basis taxation.

Where possible, we attempt to measure the net revenue impact of a tax treaty. This is generally possible, however, only for some issues in treaties with our largest treaty partners, where data are available. In such cases, we take into account the revenue impact as one element in our policy determinations. In most cases, however, data are not available in sufficient detail to permit the measurement of revenue effects. In these cases where, in any event, the magnitudes are likely to be small, our negotiating positions are primarily premised to achieving the broad objectives of avoiding double taxation and assisting the Internal Revenue Service (IRS) in the administration of the tax laws.

DEVELOPING COUNTRY TAX TREATIES

Eight of the treaties before you today are with developing countries. This represents a major step forward in our income tax treaty program. To date, we have very few treaties in force with developing countries. In the past, these countries have been reluctant to enter into tax treaties with the United States, largely because of our inability to agree to the inclusion of an explicit incentive for U.S. investment in the treaty partner. In recent years, as reflected in today's agenda, an increasing number of developing countries have accepted the view that an income tax treaty with the United States can be a valuable tool in a campaign to attract investment, even in the absence of an explicit investment incentive. The Administration believes that it is important for these treaties to be brought into force as quickly as possible, both in order to improve economic relations with these countries and strengthen their development process, and to encourage other developing countries to negotiate treaties with the United States.

It has long been recognized that tax treaties between developed and developing countries pose particular kinds of problems that are not adequately dealt with in the OECD and U.S. Models, which were designed for treaties between developed countries. In that regard, the United Nations convened a Group of Experts in 1968 to study this problem. The United States has been an active participant in this Group, whose work culminated in 1980 with the publication of a Model Income Tax Treaty between Developed and Developing Countries. Though this Model is based, in form, on the OECD Model, it deviates in many significant respects, as I will indicate.

The essence of the developing country treaty problem can be summarized as follows. In the typical bilateral economic relationship between a developed and a developing country, capital, technology and services flow in substantial part to the developing country and the income therefrom flows in large part from the developing country to the developed country. In a standard OECD-type tax treaty, it is the source country which makes the major revenue sacrifice. This places the developing country on the horns of a dilemma. It recognizes that it must reduce its frequently high source basis taxation in order to attract and hold foreign capital and technology, but it cannot afford the revenue sacrifice which would result from entering into a standard income tax treaty.

The solution typically sought by developing countries, as reflected in the U.N. Model, is to reduce source basis taxation to some extent, though not to the extent of the standard models, and to ask the developed country to compensate the developing country for the revenue cost which is incurred by providing an incentive in the treaty for their residents to invest in the developing country. The incentive typically sought is the so called "tax sparing credit," more properly "a credit for taxes spared" by the developing country. Under this type of a provision, a developed country, like the United States, which avoids international double taxation by means of a foreign tax credit, would give a credit for the developing country taxes which would have been paid but which were reduced or eliminated as a result of either a statutory provision granting a tax holiday to attract foreign capital, or under a provision contained in the treaty.

Historically, the United States has not extended such provisions to developing countries. Though this is not the appropriate time to discuss tax sparing or other incentives at length, it should be noted that the Senate has, over the years, rejected any efforts to grant such incentives which reduce by treaty the U.S. tax liability of U.S. investors.

The United States has, however, responded in its treaty policy to the other concern of developing countries—their need to conserve scarce revenues. When the provisions contained in these treaties with developing countries that are before you today are compared with the U.S. Model, it may be seen that we are prepared to be quite flexible in adapting the Model provisions to the needs of developing countries. In effect, Treasury has followed the approaches taken in the UN Model.

Of the treaties before this Committee today the one which most nearly represents a "U.S. Model" for developing country treaties is the underlying treaty with Jamaica. In that treaty, and to some extent in the others, we have lowered the thresholds for source basis taxation of both business income and personal services income. This is accomplishied by reducing the time or activity tests necessary for the source country to tax the income of a resident of the other, or by imposing dollar thresholds for the right of the source country to tax. Similarly, the maximum rates of withholding tax permitted by the source country on dividends, interest and royalties are higher than those provided for in the U.S. Model. They are, however, generally low enough to avoid excessive levels of taxation in the source country so as not to discourage U.S. investment in these countries. Thus, while Jamaica, for example, is not required to reduce its tax on U.S. residents to the same extent as would be expected of a developed country partner, there are significant reductions and, consequently, there are benefits to U.S. investors in comparison with the situation which would obtain absent a treaty. Jamaica, at the same time, by entering into a treaty, has improved the investment climate there, and made Jamaica a more attractive place for U.S. investors.

INCOME TAX TREATIES

In accordance with our usual procedure, I would like to submit, at this time, for the record, the Treasury's technical explanations of the eleven treaties. We are resubmitting the explanation of the Philippine treaty, which was submitted in 1977, at the time of the Committee's first consideration of that treaty. I would call the Committee's attention to the fact that we have replaced one paragraph in the explanation of Article 1 (Taxes Covered) to correct an error. I would also like to point out that while explanations of the Canadian and Norwegian treaties were published previously, they are being formally submitted to the Committee for the first time. The explanations of Article XXIV (Elimination of Double Taxation) of the Canadian treaty and Article X of the Norway Protocol, amending Article 23 (Relief from Double Taxation) of the Convention, in the documents submitted today, differ from the explanations as originally published. The Treasury Department will publish, in the near future, further explanation of the more detailed rules in those Articles.

With this general description and the technical explanations as background, let me turn now to a discussion of the special features of the individual treaties before you.

DEVELOPED COUNTRIES

I would like to deal first with the two treaties with developed countries—a new treaty with Canada to replace the existing treaty and a protocol revising certain provisions of our existing treaty with Norway.

CANADA

The proposed income tax treaty with Canada replaces a treaty with Canada signed in 1942 and last amended in 1966. The proposed treaty also terminates the 1961 estate tax treaty between the United States and Canada, as Canada no longer has an estate tax.

The tax treaty relationship between the United States and Canada, which has existed for almost 40 years, has proved to be extremely important to U.S. and Canadian taxpayers and to the tax administrations of both countries. The 1942 treaty has helped many taxpayers avoid double taxation and has allowed the IRS and Canadian tax authorities to cooperate with each other by, for example, exchanging information, auditing taxpayers simultaneously, and settling cases to avoid double taxation.

The proposed treaty is designed to modernize and improve this important relationship. The proposed treaty is needed because, as mentioned earlier, the tax laws of the United States and Canada have undergone important changes which are not reflected in the 1942 treaty. Also, tax treaty policy in Canada and the United States has advanced since the 1942 treaty was ratified and even since the treaty was amended in 1966. Moreover, the 1942 treaty does not adequately address the tax treatment of a growing number of transactions with complex international double taxation ramifications.

Because of the variety and number of important business transactions between the United States and Canada, and some important differences between the tax laws of Canada and the United States, the proposed treaty with Canada is more ambitious, detailed and complex than any other U.S. tax treaty. The proposed treaty addresses explicitly many issues that in other treaties are left to be resolved under powers delegated to "competent authorities." These detailed approaches to specific problems are explained in the Treasury's technical explanation of the treaty.[1] The significant provisions of the treaty can be summarized as follows.

The rates of withholding on passive income in the proposed treaty are, in general, reduced from those in the 1942 treaty. These reductions in withholding tax should provide significant benefits to U.S. investors in Canada. For example, the proposed treaty is the first treaty in which Canada has agreed to lower its rate of withholding tax on dividends below 15 percent. U.S. direct investors receiving dividends from Canadian companies will be taxed by Canada at a rate of 10 percent under the new treaty. This important reduction in Canadian tax reflects the fact that Canadian internal law provides a non-refundable credit equal to 50 percent of the dividend to Canadian resident shareholders receiving dividends from Canadian companies. The United States also agreed to a 10 percent rate on direct investment dividends paid by U.S. companies to Canadian companies. In the case of portfolio dividends, the rate of withholding is the same as under the 1942 treaty, 15 percent for investors of both countries.

The rate of withholding tax on interest is 15 percent, as under the 1942 treaty. It should be noted, however, that the proposed treaty provides five exceptions to the 15 percent tax on interest so that significant amounts of interest will not be taxed at all by the country of source. For example, interest from sources in one Contracting State beneficially owned by, or paid with respect to debt obligations insured by, the Government of the other Contracting State is exempt in the source State. Also, interest received from sources in one State by a seller who is a resident of the other is exempt in the source State, if it is paid by a purchaser in connection with certain sales of equipment, merchandise or services.

Under the proposed treaty, royalties from intangibles may be withheld upon at source at a maximum rate of 10 percent, rather than 15 percent as provided for in the 1942 treaty.

Royalties from natural resources are taxable at source, pursuant to each country's laws. This means Canada will, pursuant to its internal law, impose tax on such royalties derived by a U.S. resident at a rate equal to 25 percent of the gross royalty and the United States will, pursuant to the Code, generally tax such royalties derived by a Canadian resident at a rate equivalent to 30 percent of the gross amount. This provision is, in general terms, consistent with the U.S. and OECD Models. In contrast, under the 1942 treaty, natural resource royalties are taxable at source at a maximum rate of 15 percent.

The proposed treaty modernizes rules in the 1942 treaty concerning the taxation of business profits. Under the proposed treaty, business profits from certain activities, such as the temporary use of substantial equipment, will not be taxable in the country of source. The United States can tax foreign source business profits attributable to a U.S. permanent establishment of a Canadian resident.

Because there is substantial land, sea and air transportation between the United States and Canada, and the potential for double taxation on profits from such activities is great, the treaty expands the usual source basis tax exemption for income from international shipping and aircraft to encompass income from certain activities of railroads, lessors of rolling stock and common carriers. Thus, a significant range of transportation activities can be carried on between the two countries without being subject to potential double taxation.

In the case of income from services, the proposed treaty generally conforms to rules in the OECD and U.S. Models. One difference from these Models is that under the proposed treaty an employee resident in Canada or the United States and temporarily working in the other country will not be taxed by the latter country in any case where his compensation does not exceed $10,000. Thus, even if a Canadian resident's employer has a permanent establishment in the United States, the employee's compensation will not be taxed by the United States so long as the compensation attributable to his U.S. work is $10,000 or less. This provision, which is reciprocal, assures that the compensation of many U.S. and Canadian residents temporarily working in the other country are not taxed by that country solely by reason of that visit.

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[1] This explanation was reviewed with the Canadian officials who participated in the treaty negotiations. In a news release dated Feb. 4, 1981, Canadian Finance Minister Maceachen confirmed that the explanation reflects understandings reached in the course of negotiations with respect to the interpretation and application of the treaty. The revisions made to the explanation of article XXIV were also reviewed by the Canadian officials.

The treaty also contains rules dealing with the taxation of income derived by artistes and athletes. These rules are similar to those in other U.S. tax treaties and are designed, in part, to provide protection from tax by the country of source. In the proposed treaty with Canada, an artist or athlete is not taxed by the country of source, if his earnings, as such, are less than $15,000 and, in the case of independent personal services, he has no fixed base in the country of source. These rules also address various "loan-out" arrangements that the United States and other countries have encountered with respect to artistes and athletes. The proposed treaty provides that income of employees of teams with regularly scheduled games in the United States and Canada, such as employees of the National Hockey League, are dealt with under the general dependent services rules rather than the rules concerning the income of artistes and athletes.

The gains article of the treaty differs significantly from the 1942 treaty; for example, the proposed treaty generally allows taxation by a country of gains derived by a resident of the other country from the alienation of real property in the first country, in contrast to the 1942 treaty, which, in most cases, assigns exclusive taxing authority to the country of residence.

The proposed treaty also allows source basis taxation by the United States or Canada when a resident of the other country (e.g., Canada) alienates shares forming a substantial interest in a company not resident in the other country (e.g., a non-Canadian company) and the value of the shares is derived principally from real property in the first country (United States). Thus, for example, taking into account relevant Code provisions, gain derived by a Canadian resident from the sale of his stock in a U.S. company is subject to taxation by the United States, if the value of the shares is derived principally from U.S. real property. So too, gain derived by, for example, a resident of Canada from the alienation of an interest in a partnership, trust or estate, the value of which is derived principally from real property in the United States, is also subject to taxation by the United States. However, the foregoing rules are subject to a limitation, viz, that the right to tax gains from the alienation of such stock and partnership interests depends on whether Canada would, in comparable circumstances, impose tax on such gains under its domestic law.

Certain provisions in the gains article of the treaty are designed to deal with differences between Canadian law and the Code concerning when an alienation of property generates income for tax purposes in order to prevent potential international double taxation. For example, a Canadian citizen who becomes a resident of the United States and then makes a gift to another U.S. resident of property that, under the treaty and Canada's domestic law, generates taxable income to the donor, receives a stepped-up basis for purposes of future U.S. taxation of the property.

The treaty provides other forms of relief for other cases—such as corporate reorganizations—where international double taxation could otherwise arise because one country's domestic law defers taxation with respect to gain from an alienation of property while the other country's laws require the recognition of income from such alienation. These provisions are described in the technical explanation.

The gains article also provides a transitional rule reducing the amount of gain subject to taxation where a resident of one country alienates property which may be taxed in the other country, if it was owned by a resident of the first-mentioned State on the date of signature of the treaty.

The proposed treaty also contains provisions dealing with the taxation of pensions and annuities arising in Canada or the United States and paid to a resident of the other country. Generally, such pensions and annuities may be taxed at up to 15 percent in the country in which they arise. In the case of annuities, a second rule provides that the country of source may impose tax on only the portion of the annuity payment liable to tax by the country where the recipient of the annuity resides. The proposed treaty also covers the treatment of social security payments, which are taxable only by the paying country, and alimony and child support which are taxable only by the country where the recipient resides.

The treaty contains rules similar to those in the 1942 treaty concerning the deductibility of contributions by a resident of the United States or Canada to a charitable organization in the other country. In the case of contributions by a U.S. person to a Canadian charitable organization, such contributions will be deductible for U.S. tax purposes, so long as they do not exceed the percentage limitation of the Code as applied to income of the person arising in Canada. In the case of contributions by a U.S. person to a Canadian college or university at which he or a member of his family is or was enrolled, the U.S. contributor may claim deductions in excess of his income from Canada, but not in excess of the amount allowable pursuant to the percentage limitations of the Code. The provision concerning contributions to an alma mater allows greater deductions than allowed for such amounts under the

1942 treaty. These provisions are reciprocal and thus apply to a Canadian making contributions to U.S. charitable organizations.

The treaty also provides that the income of religious, scientific, literary, educational or charitable tax exempt organizations of Canada or the United States is also exempt from tax by the other country. Also, dividends and interest derived by certain tax-exempt pension funds or retirement plans are exempt from tax by the other country pursuant to the treaty.

As is generally the case in U.S. tax treaties, the proposed treaty contains provisions designed to avoid double taxation by the United States and Canada where, under the treaty, one country has the right to tax income as the country of source and the other country may tax on the basis of residence. The problem of double taxation is avoided by, in general, assuring that where Canada or the United States has the right to tax income of a resident of the other country, the country of residence will give a foreign tax credit for the tax imposed at source.

The U.S. foreign tax credit allowed by the treaty applies to specified Canadian taxes imposed with respect to income from Canadian sources, as provided in the treaty. There are two types of benefits a taxpayer may derive from the treaty credit rules. First, because the treaty contains its own source rules, it is possible that a U.S. taxpayer with operations in Canada will be viewed under the treaty as having a greater amount of Canadian source income than he would have under the rules of the Code. Under the treaty, this additional Canadian source income may be taken into account by the taxpayer to increase the allowable foreign tax credit in the United States. Second, because the treaty guarantees a U.S. foreign tax credit for specified Canadian taxes, regardless of whether those payments are creditable under the Code, a taxpayer might benefit from the treaty by crediting amounts that would otherwise not be creditable under the Code. These treaty benefits are subject to certain restrictions.

Thus, the treaty credit provisions may provide benefits not otherwise available, in an effort to resolve double taxation issues between the United States and Canada. If a taxpayer does not want to rely upon the provisions of the treaty concerning the foreign tax credit, he does not have to do so.

The treaty contains a number of important administrative provisions. First, like the 1942 treaty, the treaty allows the competent authorities of the two countries to settle Code section 482 cases. Thus, if IRS proposes an increase in a person's U.S. tax liability with respect to non-arm's length transactions with a related person in Canada, the treaty contemplates that there will be a corresponding adjustment in Canada so that Canadian tax liability on the transactions is decreased, if the Canadian tax authorities agree with the proposed IRS adjustment.

In this context, it is the preferred U.S. position that a treaty partner override any internal statute of limitations in order to make such a corresponding adjustment. Canada has not, however, been willing to use its tax treaties to override its statute of limitations. As a compromise, the United States and Canada have each agreed in the treaty to override its statute of limitations only if notice of the potential tax adjustment is received from the other country within six years of the year to which the adjustment relates. Thus, if the United States is considering a pricing adjustment that would increase a U.S. person's U.S. tax liability, and notice is given to the Canadian tax authorities of this potential adjustment within six years from the end of taxable year to which it relates, Canada will be able to make a corresponding adjustment even after the period provided in its statute of limitations.

As part of this compromise, the United States and Canada have also agreed that if timely notice is not given, then the country considering the adjustment must unilaterally reduce the adjustment to the extent necessary to avoid double taxation by Canada and the United States, Thus, if notice is not given to Canada within the six year period, and the person to whom the U.S. adjustment relates has not received notification of the adjustment from the United States at least six months prior to the end of that six year period then, pursuant to the treaty, the United States will not make the adjustment to the extent it would give rise to double taxation of income by the United States and Canada.

These provisions are intended to assure taxpayers that if, in section 482 type cases, potential adjustments are not raised by the IRS or Revenue Canada within six years of the taxable year in question, such adjustments will not give rise to double taxation by Canada and the United States. The provisions just explained are, of course, reciprocal. These provisions do not apply in cases of fraud, willful default or neglect or gross negligence.

The treaty contains stronger protections against tax discrimination than does the 1942 treaty. The proposed treaty protects citizens of the United States and Canada from tax discrimination by the other country whether the citizens are resident in the other country or in a third country. A special rule allows a Canadian resident who is married and works in the United States as an employee to file a joint return for purposes of computing his U.S. tax liability.

The treaty goes beyond the 1942 treaty by providing companies with protection against discrimination. The United States and Canada have agreed that a company resident in the United States or Canada and owned by residents of the other country shall not be subjected in the host country to taxation that is more burdensome than that to which similar companies owned by residents of a third country may be subjected. This "third country" protection is not as broad as the preferred U.S. position on matters of discrimination affecting companies. The U.S. and OECD Models would provide that, for example, a Canadian company owned by U.S. residents could not be taxed by Canada in a more burdensome manner than if the company were owned by Canadian residents. Canada has not, however, agreed to provide this type of protection in its tax treaties and in the commentary to the OECD Model Canada explicitly reserves on the entire Article of the Model concerning non-discrimination. The provision in the proposed treaty is the most comprehensive of any Canadian nondiscrimination Article.

The treaty does not address a form of indirect tax discrimination by Canada which affects U.S. broadcasters. Canada's tax law, C-58, denies a deduction to any person for the expense of advertising aimed primarily at a Canadian audience and placed on U.S. radio and television stations. While this type of discrimination is not generally the subject of tax treaties, Treasury emphasized in the negotiations of the proposed treaty that Treasury believes C-58 is unfair and an ill-advised use of Canada's tax system. I want to emphasize that this Administration intends to pursue all available means to convince Canada that it is time to resolve this dispute.

The treaty modernizes provisions of the 1942 treaty dealing with the so-called "mutual agreement procedure." Under this procedure, the competent authorities of Canada and the United States are authorized to resolve difficulties or doubts about the interpretation or application of the treaty. Two competent authorities can agree, for example, that a term in the treaty will be interpreted in the same way by the United States and Canada, notwithstanding differences between the Code and Canada's domestic law. Not all terms used in the treaty are defined by the treaty and, as a general matter, an undefined term is interpreted based on the context in which it appears in the treaty and the domestic law of the country whose tax is at issue. Because the domestic laws of Canada and the United States differ in many respects, it is necessary to assure that such differences can be resolved so that the provisions of the treaty fulfill their objectives and in a reciprocal manner.

The mutual agreement procedure also recognizes that a treaty is intended to last a long time—the existing treaty is, as I said, almost 40 years old—and dollar amounts specified in the treaty may not reflect economic conditions over the life of the treaty. Thus, the competent authorities are authorized to increase such dollar amounts if they agree that monetary or economic developments so require. It is important to note that any such increase benefits taxpayers because dollar amounts are used in the treaty to eliminate source basis taxation below the specified amounts. Raising an amount reduces source basis taxation of income derived by residents of the other country.

In general, the provisions of the proposed treaty have effect for taxes imposed during periods beginning after the exchange of instruments of ratification. In some cases, however, benefits are provided on a retroactive basis. For example, the principles of special foreign tax credit source rules, which are designed to resolve double taxation problems for U.S. citizens resident in Canada, have effect for taxable years beginning on or after January 1, 1976.

NORWAY

Our income tax treaty with Norway entered into force in 1972. The principal purpose of the proposed Protocol is to incorporate into the treaty the special tax on submarine petroleum resources which was first enacted by Norway in 1975. The special tax is imposed on income from oil and gas operations in the Norwegian fields of the North Sea, in addition to the ordinary corporate tax. At present, the basic corporate tax rate is 50.8 percent on retained profits and 31.8 percent if all profits are distributed. The special tax is 35 percent, though the base of the corporate and special taxes differs.

The Protocol adds the special tax to the list of taxes covered by the treaty. The Protocol also provides a special foreign tax credit limitation for taxpayers subject to the special tax which, in effect, generally applies only if they could not claim a credit for the Norwegian tax under the standards of the Code. The amount of Norwegian corporate and special tax which may be credited by virtue of the treaty is limited to the U.S. tax on Norwegian extraction income, with a limited provision for carrying over excess amounts. Similarly, the amount of Norwegian tax which may be credited on (a) other Norwegian source of oil related income and (b) other Norwegian source income (not oil related) are subject to separate per country limitations; but any excess credits may be carried over to other years.

The Protocol also provides special rules governing the taxation of business profits and wages from offshore activites. Offshore business activities carried on for more than 30 days in a twelve month period are deemed to constitute carrying on business through a permanent establishment. Employment in offshore areas is taxable at source to the extent that it lasts longer than 60 days during the tax year, unless it is exempted by a special agreement between the competent authorities in certain cases where offshore activity is carried on in more than one country.

The Protocol establishes a single maximum withholding rate at source on dividends of 15 percent, eliminating the 10 percent rate formerly applicable to direct investment dividends. This change was made at the request of Norway in order to compensate, in part, for the revenue loss of its reduced corporate tax rate burden on distributed profits and to establish a uniform treatment of foreign investors in its treaty network. Other Norwegian tax treaties are being revised accordingly.

The Protocol permits a tax at source on certain interest not to exceed 10 percent, instead of the general exemption at source previously required in the treaty. Norway does not now tax interest paid to nonresidents, and as long as either State has a statutory exemption, the other State will exempt on the basis of reciprocity. Moreover, the Protocol specifically preserves a reciprocal exemption at source for certain interest, such as interest paid to the other State, interest on bank loans, interest on credit sales of merchandise and interest on obligations outstanding on September 19, 1980.

The other provisions of the Protocol are mainly to clarify treaty provisions or to bring them more into line with the U.S. Model.

DEVELOPING COUNTRIES

As I discuss the pending treaties with developing countries, you will see, as a common theme, the feature which I described earlier—greater ability to tax by the country of source than is true in most treaties with developed countries. The extent to which this is true varies substantially among the seven treaties. The two which reflect this feature most clearly are the proposed treaties with Jamaica and Argentina. I will discuss these two first.

JAMAICA

The proposed treaty with Jamaica was signed on May 21, 1980. A Protocol amending that treaty was signed on July 17, 1981. The treaty, as amended by the Protocol, will replace the extension in 1959 to Jamaica of the 1945 Income Tax Convention between the United States and the United Kingdom.

The treaty, in general, follows the pattern of the U.S. Model income tax treaty, although there are some deviations to accommodate Jamaica's status as a developing country. As I have indicated, the underlying Jamaican treaty may be considered as a model U.S. treaty for developing countries. Most of the special provisions in this treaty can be found, in similar if not identical form, in one or another of the treaties before you today.

As in the U.S. Model, business profits of an enterprise of one country may be taxed by the other only if they are attributable to a permanent establishment in the other country. In the proposed treaty, however, the definition of a permanent establishment is more broadly drawn so that a lesser degree of economic contact is required in order for a permanent establishment to exist. For example, in the Jamaican treaty a permanent establishment will exist if technical services are provided or if substantial equipment is maintained in a State for a specified time period even if, under the Model treaty rules, there would not be considered to be a permanent establishment. Similarly, in the U.S. Model an individual who is a resident of one State may be taxed by the other on income from personal services performed in the other State only if certain tests are met. In the proposed Jamaican treaty, however, the time threshold is shorter for independent services and a dollar threshold is added. With respect to entertainers, the dollar threshold is lower than in the U.S. Model.

Maximum rates of tax are established on a reciprocal basis for the taxation by the source country of dividends, interest and royalties, which, in general, exceed the rates specified in the U.S. Model. The rates, however, are consistent with those established in other U.S. treaties with developieng countries. For dividends, the maximum rate, in general, is 15 percent, as in the U.S. Model, though the lower 10 percent rate is provided for subsidiary dividends exceeds the rate specified in the U.S. Model.

Interest is taxable at the source at a maximum rate of 12.5 percent; however, interest received, guaranteed, or insured by Jamaica or the Untied States is exempt. Royalties, including motion picture royalties, are subject to a maximum rate of tax at source of 10 percent.

The capital gain provision provides for tax on the alienations of stock of a company or interest in a partnership, trust or estate if the assets of such entities consist principally of immovable property located in the other Contracting State.

The treaty differs from the U.S. Model by including provisions dealing with directors' fees and teachers.

The exchange of notes to the treaty sets forth certain understandings between the Governments. It deals, among other matters, with the conditions under which the United States would allow a foreign tax credit for Jamaican income taxes on bauxite profits. The exchange of notes confirms the fact that the treaty has been designed to cover a substitute tax which may be imposed by Jamaica "in lieu of" the corporate income tax on such profits if such substitute tax meets the requirements of section 903 of the Code.

The central feature of the proposed Protocol is the introduction of a new provision in Article 25 (Non-Discrimination) of the treaty to provide, in effect, "North American treatment" to Jamaica with respect to specified ordinary and necessary business expenses incurred in attending business conventions in Jamaica. Under present law such expenses are deductible for conventions held outside the United States and its possessions only for conventions held in Canada and Mexico, unless it can be shown that it is as reasonable to hold the convention in the particular foreign location as it would be to hold it in the United States. Under the Protocol, expenses for any business convention held in Jamaica, if they are ordinary and necessary business expenses, will be deductible in the same way as if the convention were held in the United States. Ordinary and necessary business expenses are defined to mean expenses for lodging, meals and personal sustenance, expenses for registration at the convention and convention materials, and travel expenses. With respect to travel expenses, they are deductible only to the extent allowable under U.S. law generally for business travel outside the United States.

The inclusion of the foreign convention provision in the Protocol was motivated by the Administration's desire to implement measures which would provide tangible economic benefits to Jamaica.

There are also compensating benefits for the United States, in that the Protocol would include provisions to limit potential abuse of the treaty by denying treaty benefits in certain situations where benefits are not intended The most significant of these is a new Article 17 (replacing the corresponding Article in the treaty) which has as its purpose the denial of treaty benefits to residents of third countries who establish a corporation or other entity in one of the Contracting States for the principal purpose of obtaining treaty benefits from the other Contracting State. Though this was also the intent of Article 17 in the Treaty as originally signed, that provision is less effective and more limited than the provision in the Protocol. The Protocol provision would deny benefits to a corporation or other entity in one of the Contracting States which is established by residents of third countries, or which uses its income to meet liabilities to residents of third countries. An exception provides that if it is determined that the acquisition, ownership, or maintenance of that corporation or other entity did not have as a principal purpose obtaining treaty benefits from the other Contracting State, treaty benefits will not be denied. Thus, for example, if a third country corporation establishes a subsidiary in Jamaica which satisfies the criteria of the exception and, in connection with its normal business activities, the Jamaican corporation derives income from the United States, relevant treaty benefits would apply with respect to the U.S. source income of the corporation despite its ownership of residents of a third country, but not if a substantial part of the Jamaican corporation's income is used to meet liabilities to third State residents. Similarly, in another exception, if there is substantial trading of the stock of the Jamaican corporation on a recognized stock exchange in either the United States or Jamaica, that corporation will be considered to be owned by residents of Jamaica regardless of the actual residence of its shareholders.

It is also significant to the Administration that there was a commitment by Jamaica to enter into negotiations designed to enhance and formalize modern treaties on extradition and mutual legal assistance on criminal matters.

ARGENTINA

If ratified, the treaty with Argentina would be the first U.S. tax treaty with a South American country. There is substantial U.S. investment in Argentina and the negotiation of a treaty was encouraged by U.S. business interests. The treaty as signed is more limited than most U.S. treaties, but we believe it represents a reasonable compromise between two very different tax systems, and that it should be beneficial in easing the flow of capital between the two countries.

Argentina taxes all income derived from sources within Argentina by residents and nonresidents. It does not tax income arising outside Argentina. Therefore, the typical concern of developing countries—that reducing their tax at source in a treaty involves a revenue loss which may not be compensated by benefits they derive from the treaty—is magnified in the case of Argentina. Any rate reductions at source by the United States on income derived by residents of Argentina benefit those residents but they do not compensate the Argentine government for its reduced taxes, because the U.S. income does not enter Argentina's tax base.

Consequently, the treaty does not require any reduction in tax on royalties or on certain interest, such as interest on securities. Instead, the two Governments agreed to consider revising those articles of the treaty should statutory rates increase significantly. (The Argentine statutory rates are 11.5 percent on interest and copyright royalties, and 18 percent on licensing royalties under approved contracts.) However, Argentina agreed to exempt at source certain interest: interest paid to the U.S. Government or an instrumentality thereof, such as the Federal Reserve Board, the Export-Import Bank or the Overseas Private Investment Corporation, and interest paid to other U.S. residents when the debt is insured or guaranteed by the U.S. Government or an instrumentality thereof and is used to finance imports of capital goods for industrial use. These provisions are reciprocal.

In the case of dividends, Argentina wanted to reserve the right to increase its withholding tax (now 17.5 percent) to 20 percent, but agreed that it would do so only if it made a corresponding reduction in its corporate tax sufficient to maintain the present combined burden at no higher than 45 percent, which is roughly the present level (corporate tax of 33 percent plus a 17.5 percent withholding on the remaining 67 percent; 33 plus 11.725 equals 44.725) and is comparable to the U.S. corporate rate of 46 percent. The United States will reduce its withholding tax on dividends paid to residents of Argentina from 30 to 20 percent.

The provisions of the treaty concerning taxation of capital gains and director's fees allow greater taxation at source than is provided for the in U.S. Model.

The provisions concerning business profits and personal service income are similar to those of the U.S. Model. The noteworthy exceptions are that Argentina reserves the right to tax the profit of a U.S. resident on the purchase and export of Argentine products, and that payments for film rentals and leasing of equipment will be treated as royalties. If a U.S. person purchases goods in Argentina and exports them through an Argentine exporter there is no Argentine tax on the U.S. person, but if the U.S. person handles the purchasing and exporting, he is taxed as if he were an Argentine exporter. In the case of film rentals, the Argentine tax is 45 percent on a presumed profit of 50 percent of the gross amount and, in the case of equipment leasing, the tax is 45 percent of the lease payments, net of expenses incurred in Argentina and for transportation and depreciation.

Argentina imposes a penalty tax on remittances of profits in excees of a specified percentage of capital registered in Argentina. It also imposes tax on remittances out of Argentina of profits that have enjoyed a tax holiday in Argentina to the extent that those profits will have to pay tax in the investor's home country. Neither of these taxes is covered by the treaty. Argentina will apply them in accordance with its internal law, and the United States will judge whether they qualify for a foreign tax credit in accordance with its internal law.

EGYPT

Our proposed treaty with Egypt was signed on August 24, 1980. This replaces, and duplicates with several modifications, the treaty signed on October 28, 1975. At the request of the Treasury in 1977, consideration of that treaty by this Committee was deferred until certain changes, reflected in the 1980 treaty, had been made.

Article 11 of the treaty dealing with dividends, differs in form, in respect of the Egyptian treatment of dividends, from our normal pattern. These differences are necessary to accommodate certain features of Egyptian law. While the treatment of U.S. source dividends in paragraph 2 follows the general form of a 15 percent rate on portfolio dividends and a 5 percent rate on dividends paid to direct investors, paragraph 3 provides what appears to be substantially higher taxation for Egyptian source dividends. It provides for the imposition of a list of taxes on all Egyptian source dividends paid to U.S. residents and, in addition, if the U.S. shareholder is an individual, the general income tax may be imposed at a maximum average rate of 20 percent. While this may appear on the surface to represent a substantial Egyptian tax burden, I would like to explain why we feel that this is not the case.

Under Egyptian tax law, the income of an Egyptian corporation is subject to a multiplicity of taxes and surcharges which, in the aggregate, currently amount to a rate of approximately 40 percent. Though dividends paid out of current year's earnings are deductible in computing the income subject to this tax, the dividend itself is subject to another set of essentially the same taxes which, in the aggregate, also amount to a rate of 40 percent. Thus, in the case of dividends paid to a corporate shareholder, whether domestic or foreign, internal Egyptian tax law provides for the integration of corporate and shareholder level taxes.

When the dividend is paid to an individual shareholder, the individual's income, after a tax-free allowance, is also subject to a progressive general income tax, applying to the dividend net of withholding tax. Under the treaty, a U.S. individual shareholder's liability for the Egyptian general income tax would be limited to an average rate of 20 percent applied to his Egyptian source taxable income.

For example, if an Egyptian corporation earns £10,000 its tentative Egyptian tax liability will be £4,000. If however, it chooses to pay £10,000 as a dividend, the dividend will be deductible for corporate tax purposes; the corporation will have no taxable income and therefore no tax liability. The 10,000 dividends will be subject to tax of £4,000 which is withheld at the source leaving a net dividends of £6,000. If the shareholder is a corporation there will be no further Egyptian tax liability. If the shareholder is an individual, he will be subject to the general Egyptian income tax on the net dividend of £6,000 minus a tax-free allowance. His average rate of Egyptian tax on the dividend will not exceed 20 percent, and may be less, depending on the total amount of his Egyptian source taxable income.

Confronted with the Egyptian tax structure, we did not feel that it was appropriate, particularly when dealing with a developing country, to expect Egypt, which imposes no corporate tax on the income underlying current dividend payments, also to reduce or forego tax on the dividend payment itself. Requiring Egypt to reduce its tax on dividends to 5 to 15 percent would result in a provision which would not be reciprocal in form. However, it certainly would not be reciprocal in substance. The U.S. would collect an aggregate tax of either 48.7 percent (46 percent corporate tax plus 5 percent withholding) or 54.1 percent (46 percent plus 15 percent), while Egypt would collect only 5 percent or 15 percent. We therefore chose to view the 40 percent tax on the dividend as though it were a corporate tax. Since Egypt has no tax beyond its basic tax on dividends paid to a corporation, reciprocity could have been achieved only by the U.S. going to a zero withholding rate. We saw no need to do this. For individual investors strict reciprocity would be even more difficult to achieve. The U.S. 15 percent tax applies to the entire gross dividend. The portion of the Egyptian tax which can fairly be considered to be at the shareholder level will be imposed at a maximum average rate of 20 percent, but in many cases the actual average rate will be below this, since the first £1,200 of Egyptian taxable income is exempt and marginal rates on the next slice begin at 9 percent.

The provisions dealing with personal service income—Articles 15, 16, and 17 (Independent and Dependent Personal Services and Public Entertainers, respectively) are modified somewhat, in comparison with our normal model, and reflect the flexibility in our negotiating posture with developing countries. Our standard rule has been that when an individual who is a resident of one country visits the other country to perform personal services, either in an independent capacity or as an employee, the host country may tax the remuneration for services performed there if he is present in the country for more than 183 days in the taxable year. Developing countries frequently note that individuals will often come for relatively brief periods of time and earn substantial income. Under internal law this income will be subject to tax in the host country, while under tax treaties it will normally be free of tax. In the treaty with Egypt we agreed to a 90 day rule for both independent and dependent personal services. While we might agree to such a provision in another treaty with a developing country, where we recognize a legitimate concern over possible erosion of the tax base, we would not normally consider this appropriate for a treaty with another developed country.

With respect to public entertainers, a different rule, found in Article 17, is used. In the case of such individuals who are residents of one State performing in the other, the host State may tax if the income exceeds $400 per day, without regard for the amount of time spent. Similar provisions are found in a number of our treaties including the proposed treaty with Israel, and our treaties with Trinidad and Tobago and Romania.

I would like to turn now to Article 26 (Non-Discrimination). We consider this a very important provision in our income tax treaties. The treaty with Egypt contains the normal guarantees of national treatment under all Egyptian taxes for U.S. citizens and permanent establishments and for Egyptian corporations owned by U.S. residents.

In paragraph 2, dealing with permanent establishments, you will notice two exceptions. In several treaties where national law treats a branch of a foreign corporation differently from a resident corporation, and that distinction is of only minor importance, we have agreed to except these provisions from the nondiscrimination protection. That was the case with the two exceptions in the Egyptian treaty.

The first exception, in paragraph 2(b), states that Egypt is not required to extend to U.S. corporations the exemptions granted to Egyptian corporations under Articles 5 and 6 of Egyptian Law 14 of 1939. Article 5 exempts certain foreign source investment income which an Egyptian insurance company earns on reserves which are required by foreign law to be deposited in a foreign country. Under Article 6, if an Egyptian investment company pays tax on its dividend and interest income, then certain of its distributions will be exempt in the hands of the shareholder.

The exception in paragraph 2(c), preserving the rules in Articles 11 and 11 bis. of Law 14 of 1939, relate to the Egyptian treatment of branch profits. Under these provisions of Egyptian law, an Egyptian branch of a foreign corporation is treated for certain purposes as though it was an Egyptian corporation. Its profits are deemed to be distributed and are treated as dividends and the tax on those deemed dividends are imposed on the branch. Thus, a branch of a foreign corporation is subject to a tax on deemed distributions while an Egyptian corporation is not so subject. Although the Egyptian corporation's actual dividends are subject to Egyptian withholding, that tax falls on the recipient and not on the paying corporation. Paragraphs 5 and 6 of Article 11 (Dividends) provide for this treatment, and paragraph 2(c) of Article 26 confirms that this treatment, though technically discriminatory, will not be considered to violate the nondiscrimination article. This is consistent with exceptions to the nondiscrimination provisions of several other treaties which allow for the imposition of branch profits taxes, as, for example, in our treaty with France and the proposed treaty with Canada.

In addition to the treatment of dividends, already discussed, Article 12 provides that interest from sources within one Contracting State may be taxed by both States, but the tax in the source State may not exceed 15 percent of the gross interest. Where, however, the interest is paid to one of the Contracting States or one of its instrumentalities or to a resident of that State with respect to a loan guaranteed or insured by that State or its instrumentality, the source State will exempt that interest from withholding.

Under Article 13, the withholding tax in the state of source of royalties is limited to 15 percent of the gross royalty payment. Motion picture royalties are treated, under Article 8, as business profits. As such they may be taxed in the source State only when they are attributable to a permanent establishment which the recipient has in that State, and then only on a net basis.

As I have explained, these maximum source country withholding rates are above those provided in the U.S. Model, under which both interest and royalties are exempt at source.

ISRAEL

The proposed treaty with Israel was signed on November 20, 1975. Certain provisions of that treaty were amended by a Protocol signed on May 30, 1980. In the discussions which follows, I will deal with the treaty and Protocol as a single unit. Two earlier treaties with Israel were signed on September 30, 1960 and June 29, 1965, but were never ratified and have since been withdrawn from Senate consideration.

There are four provisions, in particular, in this treaty which I would like to discuss with you.

The first of these provisions is found in Article 10 (Grants). The article confirms U.S. law by providing that if Israel makes a grant to U.S. investors, either as a cash payment or a forgiveness of a loan, and the grant is not in payment for goods or services and is not measured by the amount of profits or tax liability, the United States will, at the election of the taxpayer, treat the grant as a nontaxable contribution to capital.

Qualifying Israeli grants would be made on the basis of how well a venture succeeds in meeting its preestablished objectives. These objectives may relate, for example, to employment generation, exports, other foreign exchange earnings, import substitutions or activities in development areas. As the treaty itself makes clear, the grants cannot in any way be related to profits or tax liability, because that would merely be a veiled form of tax reduction, and would violate our principle of not giving recognition by treaty to tax sparing in the host country.

The history of this provision goes back to 1959, when a treaty was negotiated with Israel which included a tax sparing credit designed to serve as an impetus to U.S. investment in Israel. That treaty was signed in 1960. After it had become clear that the Senate would not approve treaties with such a provision, that treaty was withdrawn. A second treaty was signed in 1965, which included an alternative investment incentive in the form of an investment credit. On the basis of Senate action on similar provisions in treaties with Thailand and Brazil, it became equally clear that the 1965 treaty with Israel could not be approved.

Though Israel had not abandoned its interest in having the treaty serve to facilitate U.S. investment, they clearly understood, during the negotiations of the treaty and Protocol before you today, that both tax sparing credits and investment credits were out of the question. The provision on Grants is a logical alternative which fits neatly into the tax treaty mechanism. Israel was considering substituting a system of direct grants for their then current system of tax incentives. If the grant is a true grant and neither a payment for goods or services nor a disguised reduction in taxes, it may be treated as a nontaxable contribution to capital under U.S. law. Though the grant would not be subject to tax when received, it would require a basis adjustment which could result in a higher U.S. tax when the assets acquired with the grant or the U.S. resident's stock in the Israeli corporation are disposed of. This treatment, which is provided for in the treaty, is consistent with U.S. statutory treatment of grants by U.S. states and municipalities.

This approach presented us with a satisfactory compromise to the investment incentive impasse. A developing country willing to substitute grants, on an acceptable basis, for tax incentives, could be assured that the U.S. tax system would not frustrate the effects of the grant. The taxes imposed by the developing country on the income generated by the investment would be creditable under U.S. law and the grant would not be subject to tax. Though this result has been established by the Israeli treaty, the treaty provision merely confirms, with some clarifying detail, the result which would obtain under U.S. law, but by doing so it calls attention to the provision and removes doubt and uncertainty in the mind of the investor.

While this may not be a general solution to the problem of dealing in tax treaties with investment incentives, the Treasury would consider including such a provision in any treaty with a developing country which employs a system of investment incentive grants.

Second, the proposed treaty provides in Article 26 (Relief from Double Taxation) that Israel's compulsory loans are to be treated as creditable taxes in the year incurred, but that when a loan is repaid, the repayment is to be treated as a refund of foreign tax with appropriate adjustments to U.S. tax liability at that time.

Though the compulsory loans are not taxes and would not qualify for credit under the Internal Revenue Code since they are subsequently repaid, the loans have the same economic effect as taxes at the time they are made, and of course, at the time the loans are made the lender cannot be certain that they will in fact be repaid. It, therefore, seems reasonable to treat them as taxes which are subsequently refunded. The effect of the provision is a deferral of tax on the income until such time as the investor has use of the income.

The Committee should be aware that this provision has only limited applicability. The system of compulsory loans is being phased out in Israel. These loans are treated as covered taxes only for corporations that became subject to the loans prior to April 1, 1977 and then only for loans made with respect to taxable years ending before April 1, 1988. Thus, U.S. investors investing in Israel now for the first time can get no benefit from this provision, and those U.S. investors who may benefit will become fewer and fewer over time. The benefits will cease altogether in 1988.

A third provision I would like to discuss is found in Article 15 (Capital Gains). In general the article follows our standard treaty rules that, with certain exceptions, capital gains are taxable only in the state of residence of the recipient of the gain. One of the exceptions, however, in paragraph (1)(e), is not found in our other treaties.

That paragraph provides that Israel may tax a U.S. resident on a gain from the disposition of stock in a Israeli corporation if the U.S. resident controls more than 50 percent of the voting power of the Israeli corporation and if more than 50 percent of the assets of the Israeli corporation are and have for the previous three years been physically located in Israel.

This provision is closely analogous to the exception in subparagraph (c) dealing with the assets of a permanent establishment, which is commonly found in our other treaties. The subparagraph (c) exception states that gains which a resident of one State derives from the other State which are effectively connected with a permanent establishment located there may be taxed by that other State.

Thus, under subparagraph (c), gains on the sale of the assets of an Israeli branch of a U.S. resident, including disposition of the branch itself, may be taxed by Israel. Under subparagraph (e), the dispostion of part or all of a subsidiary (in which the U.S. resident has a majority interest) will be similarly treated. We did not include disposition of minority or portfolio interests in an Israeli corporation because of the difficulty in tracing such transactions.

The subparagraph (e) provision is not reciprocal because sale of stock in a U.S. corporation by a nonresident (other than a real estate holding company) is not generally taxable under U.S. law, and writing such a rule in the treaty for the United States would have no effect, since we cannot impose a tax by treaty.

We have, however, in Article 7 (Income from Real Property), preserved our statutory right, on a reciprocal basis, to tax an Israeli resident on gains from the sale of shares of a company whose principal assets consist of real property situated in the United States.

The fourth special provision which I would call to your attention is found in Article 15A (Charitable Contributions). Under that provision a resident, of one country may, subject to limitations which I will describe, treat as charitable contributions for tax purposes in his country of residence, certain contributions to qualifying charitable organizations in the other country. Though the Article is reciprocal, I will describe its operation in the context of an American resident contributing to an Israeli charity.

The Article provides that if a resident or citizen of the United States makes a contribution to an Israeli organization which is both treated as a charitable organization for Israeli tax purposes and would be so treated for U.S. tax purposes if it were a U.S. organization, that contribution will be considered, for U.S. tax purposes, as a charitable contribution. The amount, however, which will be treated as a charitable contribution is limited to an amount not to exceed 25 percent of the taxpayer's income for the year from sources in Israel. Thus, for example, if an American resident has income of $1,000 from Israeli sources in a year, and he contributes $500 to a qualifying Israeli charity, only $250 of that contribution will be treated as a charitable contribution for U.S. tax purposes. The amount so treated will then be combined with all other charitable contributions of the resident and the Code limitations on the deductibility of such contribution will apply to this total amount.

Though this type of provision is not normally found in U.S. tax treaties, there is a precedent, similarly limited, in the 1942 treaty with Canada. As I noted previously, our proposed treaty with Canada also contains such a provision.

The maximum rates of withholding prescribed by the treaty for dividends, interest and royalties are somewhat higher than those typically found in our treaties. This reflects our general approach of not pressing developing countries, which have serious revenue needs, to reduce their witholding rates to the levels found in the U.S. or OECD Model treaties or in our treaties with other industrial countries.

Under Article 12, the maximum rate of tax on dividends paid by a corporation of one country into a resident of the other is 25 percent. This is reduced to 12.5 percent when the recipient is a corporation controlling 10 percent or more of the voting stock of the paying corporation, or to 15 percent in the case of a dividend paid by an Israeli subsidiary to a U.S. controlling corporation, if the dividend is paid out of income which has benefitted from reduced corporate tax rates under Israel's Encouragement of Capital Investments Law. Since the underlying Israeli corporate tax in such cases is substantially reduced, U.S. investors should, in general, be able to credit the somewhat higher Israeli withholding tax.

Under Article 13, the general maximum rate of withholding at the source on interest is set at 17.5 percent. The effect of this relatively high rate of withholding is substantially mitigated by two important exceptions to the general rule. Interest derived by a financial institution may not be taxed at a rate in excess of 10 percent. It is important that a relatively low rate be applied to such interest because financial institutions generally have large expenses associated with their interest income and a high rate of tax on the gross income translates into a rate on net income which is often too high to be fully creditable.

Under the second exception, in paragraph (3), interest derived by a Contracting State or instrumentality or interest received by a resident of the Contracting State which is guaranteed or insured by that State or its instrumentality will be exempt from tax by the other State.

The 17.5 percent withholding rate on interest is certainly higher than we would agree to with another developed country. Even with a developing country we would resist rates at that level unless there were exceptions similar to those in this treaty.

Under Article 14, industrial royalties derived by a resident of one State from sources in the other are subject to a maximum tax at the source of 15 percent. Copyright or film royalties may not be taxed at the source at a rate in excess of 10 percent.

At present, motion picture royalties derived by U.S. companies from Israel are taxed at a rate below that specified in the treaty. We have been assured, in a letter from the Finance Minister, that Israel will not use the treaty as a reason for increasing the tax.

MOROCCO

The proposed treaty with Morocco is similar in most respects to the OECD model draft convention on which the U.S. Model was based, but includes some special provisions to accommodate Morocco's needs as a developing country.

The treaty sets limits on the taxation at source of dividend, interest and royalties. The maximum rate on dividends is 10 percent on dividends paid to parent corporations (owning 10 percent of the voting stock of the paying company) and 15 percent in other cases. The 10 percent rate also applies to branch profits. Interest paid to the other Government or an instrumentality thereof (e.g., Eximbank or OPIC) is exempt from tax at source. Other interest may be taxed at a rate no higher than 15 percent. Royalties may be taxed at source at a rate no higher than 10 percent.

The definition of royalties includes film rentals, payments for accessory technical services performed in the other country in connection with the use of patents or similar rights in that country, and payments out of Moroccan Government funds for technical and economic studies performed for the Government. Like many developing countries, Morocco wanted to retain the right to tax payments by Moroccan residents to nonresidents for technical assistance. Such payments are deductible expenses in Morocco, and they wanted to recover the revenue loss by taxing the non-resident recipient. While understandable, such an approach is inconsistent with the widely accepted view that the source of employment income is where the services are performed. Moreover, under the typical treaty provision on employment income, the source country exempts such income from tax unless the recipient exceeds certain time or dollar thresholds. While Morocco could accept the traditional view as a general matter (see Articles 14 and 15 on the earnings of self-employed persons and employees), it felt that the revenue loss was too high in the case of technical assistance, such as consulting services. The compromise agreed to allows Morocco to tax payments for ancillary technical services which are performed in Morocco and fees for certain studies done for and paid for by the Government.

Another concession concerning personal service income allows Morocco to tax payments to athletes and entertainers for services rendered in Morocco without a mimimum period of presence or amount of earnings. The Moroccan position was that exempting the high amounts often paid for brief performances by well known athletes or entertainers would involve too high a revenue cost. They agreed, however, to apply the ordinary rules (of Article 15) when the athlete or performer is a member of a non-profit orgnaization. Thus, members of a non-profit U.S. symphony or ballet group would not be taxed by Morocco if they remained there less than six months of the year.

Morocco could not agree to collect the additional U.S. withholding due if nonresidents use a Moroccan address to obtain the reduced treaty rate on U.S. dividends. They did not feel they could justify putting that burden on their limited administrative resources in the absence of a U.S. commitment to assist in collecting Moroccan income tax due in other cases. The Senate has opposed such broad commitments, so the issue was resolved by deleting the provision.

The most unusual feature of the Moroccan treaty is the treatment of the amounts which corporations are required to invest in Moroccan government bonds, Under the treaty, such amounts may be treated as an income tax in the year invested, subject to any subsequent redemption being treated as a reduction in Moroccan tax in that later year. Interest will be due on the deferred tax to the extent of any interest paid on the bonds, net of Moroccan withholding tax. This is similar to the provision discussed in connection with the Israeli treaty.

THE PHILIPPINES

The treaty with the Philippines was signed on October 1, 1976. An earlier treaty with the Philippines was signed on October 5, 1964 and approved by the Senate with reservations on several provisions. That treaty was never ratified by the Philippine Government. The 1976 treaty was considered by this Committee in 1977, but no action was taken.

The treaty establishes maximum rates of withholding tax in the source country on income payments flowing to residents of the other country. The treaty reduces the statutory rates of 30 percent in the United States and 35 percent in the Philippines. The maximum rate of withholding tax under the treaty is 25 percent on portfolio dividends and 20 percent on dividends paid to a parent corporation owning 10 percent or more of the voting shares. The 20 percent limit applies also to the additional Philippines tax on profits of U.S. corporations derived through Philippine branches.

The treaty provides a maximum tax at the source of 15 percent on interest in general, 10 percent on public bond issues, and exemption of interest paid to the Government of one of the Contracting States or an instrumentality thereof, or interest on debt guaranteed or insured by that Government or instrumentality.

In the case of royalties, the treaty provides a limit of 15 percent at the source for the United States. The Philippine tax at source is also limited to 15 percent provided that the paying corporation is registered with the Board of Investments and engages in preferred areas of activity. In other cases, the Philippine tax is limited to 25 percent or to a lower rate, if a lower rate applies on comparable payments to residents of third States. This most-favored national provision means that the Philippine tax on film rentals will be 10 percent, because that rate appears in their treaty with Sweden. The Philippines agreed not to tax rentals of tangible property as royalties.

Income derived by a resident of one country from performing personal services, other than entertainment services, in the other country is exempt from tax by that other country unless the individual remains there 90 days or longer during the year or, the case of services performed in an independent capacity, if the gross remuneration exceeds $10,000 or a higher amount agreed to by the tax authorities of the two countries. (Although gross remuneration determines whether a tax liability arises, the tax would be imposed on net income.) The 90 day period is consistent with the U.S. statutory rule concerning employees of foreign companies in the United States.

The conditions for exemption of entertainers performing services in the other country are that the income for such not exceed $100 per day or $3,000 per year. This is similar, in essential respects, to the provision in our 1970 treaty with Trinidad and Tobago.

The treaty does not contain the usual reciprocal exemption of shipping and airline profits. The Philippines is strongly opposed to such an exemption and have not agreed to it in any other treaty. They agreed, in Article 9, to reduce their statutory tax from 2½ to 1½ percent of gross receipts on outbound traffic and to provide in the treaty that the tax may not exceed the lower of the 1½ percent rate or any lower tax agreed to with a third country. The treaty includes such a provision with respect to shipping profits but excludes airlines from the provision. At the time the treaty was signed U.S. airlines preferred being excluded, to avoid the precedent of a treaty provision other than reciprocal exemption. Subsequently, they have advised us that they would accept the same relief now afforded U.S. shipping companies. We had hoped to complete a protocol to that effect prior to these hearings but it appears that it will be necessary to meet with Philippine officials to discuss this issue and try to negotiate an acceptable solution. We believe that, despite this omission, the treaty as signed is beneficial to U.S. investors and should enter into force. It has already been ratified by the Philippine Government.

Article 24 of the treaty affirms the principle of nondiscriminatory tax treatment with respect to all taxes, but, as in the Egyptian treaty, there are certain specific exceptions. These exceptions allow the Philippines to reserve to Philippine nationals incentives granted under specified sections of existing law. The exceptions in brief permit: (1) a deduction for certain amounts invested in new shares of pioneer industries and a shorter holding period to qualify for capital gains treatment on the sale of such shares; (2) deduction for certain local costs of export production to firms which are 60 percent Philippine owned; and (3) limited incentives to invest in tourist facilities.

MALTA

The proposed treaty with Malta comes closest to the U.S. Model of all the treaties under consideration today. It contains relatively few provisions which require special comment.

As in the Egyptian treaty the rules for the taxation of dividend income at source (Article 10) are non-reciprocal, in order to reflect the differences in the U.S. and Malta tax systems. Malta has an integrated tax system which, though different in form from the Egyptian system, shifts the corporate level tax forward to the shareholder with respect to distributed profits. A dividend is grossed-up in the hands of the shareholder by the amount of the corporate tax underlying the dividend. The shareholder (domestic or foreign) calculates his Malta tax at ordinary rates on the basis of this grossed-up dividend, and credits the corporate tax (i.e., the gross-up) against his tax liability. In the case of a corporate shareholder there is no further tax due from the shareholding corporation with respect to the dividend income since the tax due is at the same rate as the tax for which a credit is taken. An individual shareholder is subject to progressive rates and may, therefore, receive a refund of a portion of the tax paid at the corporate level or may be required to pay additional tax, depending on the average rate of Malta tax to which he is subject.

Under the treaty, Malta has agreed to limit its tax on U.S. shareholders to the amount of tax paid at the corporate level. For U.S. corporate shareholders, therefore, there is no additional tax due on the dividend. For individual U.S. shareholders, Malta is precluded by the treaty from imposing additional tax regardless of the Malta tax rates otherwise applicable, but he may receive a refund if his individual tax rate in Malta on his Malta source income is lower than the corporate rate, for which he receives a credit.

On the U.S. side, the dividend withholding rates are, as in the U.S. Model, 5 percent on dividends paid to a parent corporation and 15 percent in other cases.

With respect to interest (Article 11), tax in the source State is limited to 12.5 percent of gross interest, except that interest received by one of the Governments is exempt at source in the other State. In the case of the U.S. tax, this 12.5 percent is a final liability. A corporate or individual U.S. recipient of interest from Malta has the option of calculating the tax due to Malta on the net income from Malta sources at ordinary rates. If this comes out to be less than 12.5 percent of the gross interest, he may file for a refund of the excess Malta tax paid.

Cultural royalties, under Article 12, are exempt at source on a reciprocal basis. Other royalties are subject to tax at source at a rate not to exceed 12.5 percent of the gross royalty. Motion picture royalties are included in this class of royalties. As with interest, the U.S. tax on royalties constitute a final liability, while the Malta tax is provisional. Thus, the U.S. licensor may file for a refund if the Malta tax on net income at ordinary rates is less than 12.5 percent of the gross.

Malta has confirmed, in an exchange of notes at the time of the signing of the treaty, that such refunds will be made.

The rules of the taxation of personal service income (Articles 14 and 15) reflect Malta's status as a developing country. The threshold for source country taxation of personal service income is 90 days, instead of the normal rule of 183 days, and, in addition, if the amount of the remuneration exceeds $10,000 in a year. The source country may tax even if the time threshold has not been met. Similarly, entertainers (Article 18) may be taxed in the source State with a lower threshold than in the U.S. Model.

BANGLADESH

The treaty between the United States and Bangladesh was signed on October 6, 1980. Though it conforms to the U.S. Model in many respects, there are several important differences which result from Bangladesh's status as a developing country.

The treaty provides maximum rates of tax in the source country for dividends, interest, and royalties. These rates, while higher than those in the United States Model, are similar to the rates adopted in other treaties with developing countries.

With respect to dividends, a maximum tax rate of 15 percent is provided for dividends received from subsidiaries, with other dividends being subject to a 25 percent maximum tax rate. Interest is subject to a 15 percent maximum tax rate, but there is an exemption for interest received by a Government or a Government instrumentality. Artistic royalties, including those received for the use of motion pictures, are subject to a 10 percent maximum tax rate, with a 15 percent rate being applicable to other royalties.

The treaty provides rules for the taxation of income derived from the performance of dependent and independent personal services which are generally similar to the provisions of the United States Model.

The treaty, like the U.S. Model and more recent United States treaties, contains a special provision for the taxation of artistes and athletes. In the Bangladesh treaty, income derived by such individuals can be taxed by the source country if the income exceeds $100 per day or $3,000 during the taxable year. These dollar thresholds are lower than those found in the U.S. Model and other treaties. They reflect Bangladesh's status as a developing country, and should have litttle practical effect since the income of U.S. entertainers performing in Bangladesh would normally exceed even a larger threshold, due to the great expense involved in traveling to Bangladesh.

Like all U.S. treaties business profits of an enterprise of one country may be taxed by the other country only if the enterprise carries on business through a permanent establishment in that other country. However, as is the case with other United States treaties with developing countries, the definition of a permanent establishment is broader than in the United States Model.

One area in which the Bangladesh treaty differs from the U.S. Model is that, under the treaty, profits derived from international shipping may be taxed by the source country. The United States prefers a reciprocal tax exemption for profits derived from international shipping. However, profit from such activities is becoming an increasingly important source of revenue for developing countries. In recent years, many developing countries have refused to exempt profits derived from international shipping from tax under income tax treaties. This was the position Bangladesh took during the negotiations. The provision was agreed to in the context of a balanced agreement which provides benefits to other U.S. businesses. In addition, United States shipping operations are not placed at a competitive disadvantage with respect to shipping operations conducted by residents of other countries. Since Bangladesh will not agree to a reduction in tax at source in treaty negotiations with other countries, a competitive advantage is not created. It is also important to note that the Bangladesh taxation of United States shipping operations is specifically subject to the nondiscrimination article of the treaty, so that United States shipping enterprises may not be subject to more burdensome taxation in Bangladesh than are Bangladesh shipping enterprises.

ESTATE AND GIFT TAX TREATIES

Purpose

The primary purpose of an estate and gift tax treaty is to alleviate international double taxation. Different countries rely on a variety of criteria in asserting estate or gift tax jurisdiction. Typical criteria include the domicile of the decedent or donor, the citizenship of the decedent or donor, the location of the property subject to tax, or the domicile or citizenship of the heir or donee. Citizens or residents of the United States, for example, are subject to estate and gift taxes on the transfer of all their property, wherever located. On the other hand, nonresidents who are not citizens are taxable only on transfers of property situated within the United States. When the jurisdictional claims of two countries overlap, international double taxation arises in that the same asset is taxed by two different countries.

The United States seeks to alleviate international double taxation unilaterally by allowing a credit for certain foreign taxes paid. Other countries pursue a similar policy by either exempting foreign property or crediting foreign taxes. But these unilateral measures, because of wide differences in taxing jurisdiction, usually leave some types of double taxation that can only be eliminated by treaty.

U.S. TREATY NETWORK

The United States has 14 estate and gift tax treaties, though the pending income tax treaty with Canada would terminate the Canadian estate tax treaty. Generally speaking, these are of two different types. All estate and gift tax treaties negotiated between 1946 and 1959 contained a comprehensive set of situs rules. Double taxation is eliminated by awarding primary taxing authority to the country in which the taxable property is situated. In 1966, the OECD published a model estate tax convention, (Draft Double Taxation Convention on Estates and Inheritances).

The OECD model, which the United States helped develop, provides for domiciliary-basis taxation. The treaties which the United States has negotiated since the appearance of the OECD model, with the Netherlands, France, the United Kingdom, and the proposed treaty with the Federal Republic of Germany, all follow this emphasis on domiciliary basis taxation. The general principle of these treaties is that the country of domicile may tax estates and other transfers on a worldwide basis, but must credit tax paid to the other country on the basis of the location of a few, narrowly-defined types of property. The U.S. model estate and gift tax treaty, published by the Treasury Department on December 8, 1980, also emphasizes domiciliary-basis taxation.

U.S. TREATY POSITION

The United States agrees with and supports the internationally-accepted position that the country of domicile should have the primary right to tax the estate of gifts of a decedent or donor. In our view, it is the country of domicile with which an individual has his most permanent economic and social attachments. It is therefore appropriate that the country of domicile be awarded the primary right to tax the accumulated wealth of that individual that is transferred by death or by gift.

In this same spirit, the United States believes that an individual should be considered a domiciliary of a country only after having been present in that country for a significant number of years. Thus, in its treaty negotiations, the United States adheres to a policy of asserting primary taxing jurisdiction over U.S. citizens and domiciliaries who have been domiciled in another country for a relatively brief period. This type of protection is contained in all our domiciliary-basis treaties.

The United States also includes a "saving" clause in its treaties, protecting its right to tax its citizens regardless of any treaty. This provision is included because under domestic law the United States taxes its citizens on a worldwide basis, wherever they are domiciled, and because the United States views a treaty as affecting its right to tax domiciliaries of the other country, but not its right to tax its own citizens.

GERMANY

The proposed estate and gift tax treaty with the Federal Republic of Germany would be the first of its kind between the two countries. It would apply, in the United States, to the Federal estate tax and the Federal gift tax, including the tax on generation-skipping transfers and, in the Federal Republic of Germany, to the inheritance and gift tax.

The treaty comports with the current treaty position of the United States to tax primarily on the basis of domicile, rather than on the basis of situs. The treaty with the Federal Republic of Germany is similiar in principle to the United States estate and gift tax treaty with the United Kingdom, which entered into force November 11, 1979, and to the estate and gift tax treaty with France, which was entered into force October 1, 1980. It is also similar to the U.S. Model estate and gift tax Convention, published by the Treasury Department on December 8, 1980. The details of some provisions in the treaty however, differ from those in either the United Kingdom or French treaties or the Model.

The general principle of the treaty with the Federal Republic of Germany is that the country of domicile may tax the estate or gifts of a decedent or donor on a worldwide basis, but must credit tax paid to the other State with respect to certain types of property located therein. Specifically, immovable property, certain business assets, and partnership interests attributable to such property are taxable in the Contracting State where situated. The treaty also contains a "saving" clause which allows the United States to tax estates and gifts of its citizens, and allows the Federal Republic of Germany to tax heirs, donees, or other beneficiaries domiciled in the Federal Republic of Germany, provided a credit is given for tax paid to the other State on either a domiciliary or situs basis.

The treaty provides rules for determining which State has the right to tax on a worldwide basis in the case of a decedent or donor who is domiciled in both Contracting States at the time of death or gift. It provides that a United States citizen who is domiciled in both the United States and the Federal Republic of Germany shall be deemed to be domiciled in the United States if he had not been domiciled in the Federal Republic of Germany for more than 5 years. The effect of this rule is that the Federal Republic of Germany may not subject the estate or gifts of a U.S. citizen and domiciliary to tax on a worldwide basis if he has been domiciled in the Federal Republic of Germany for 5 years or less. Where the 5-year rule does not apply, the treaty provides a set of reciprocal rules for resolving the issue of domicile.

The treaty provides that inter-spousal transfers may be taxed by a Contracting State on a situs basis only to the extent they exceed 50 percent of all taxable transfers. In the case of the United States, the reduction in tax is limited to the tax that would be due if the normal citizen or resident rates were applied to the tax base. In the case of the Federal Republic of Germany, the marital relief may not result in an exclusion from the taxable base in excess of the general marital deduction available to those subject to unlimited German tax liability.

With respect to estates and trusts, the treaty does not preclude a Contracting State from applying its rules governing the recognition of a taxable event. The competent authorities may discuss, and attempt to resolve, problems arising due to the differences in the timing of taxable events, provided the differences do not exceed 5 years. The beneficiary of an estate or trust may elect to be subject to all German taxation within the 5 year period in order to be eligible for competent authority relief.

The treaty does not have a Non-Discrimination Article. This is because the existing income tax treaty between the United States and the Federal Republic of

Germany has such an Article which applies to all taxes including estate and gift taxes.

In conclusion, I would urge, once again, that this Committee take prompt and favorable action on all eleven of the treaties which we are discussing today.

STATUS OF RELATIONSHIP WITH CANADA

The CHAIRMAN. Thank you very much, Mr. Chapoton.

Perhaps it would be best for you to give a little background on the status of our relationship with Canada. Ambassador Peter Towe always has been very forthright with me, and indicated that things are much rockier now than they have been in the past.

Recent United States-Canadian economic relations have been less than harmonious in the area of Canadian foreign investment policy in general and more specifically with respect to the Canadian policy with respect to its energy sector.

Could you give us a little background on that, so that we might, in context of our overall relationship, start the discussion of the tax treaty.

Mr. CHAPOTON. Mr. Chairman, we at Treasury are concerned with the tax treaty and with the ramifications of this treaty for investment. We have cooperated closely with the State Department and we are concerned about the problems you mentioned.

Secretary Regan went to Ottawa this summer, as you know. We do feel that there is an open dialog between the two countries. There are certainly matters of concern on the economic front of major concern. From Treasury's viewpoint, however, I am not prepared really to address the problems to which you are alluding, simply because we have not addressed them with the State Department.

I would say that we have taken these concerns into account. The broadcasting problem I already mentioned. Also, there are problems involving the petroleum industry in both countries. We have taken these into account in this administration's review of this treaty, which was negotiated by the previous administration.

We feel that both countries gain considerably from this treaty and that it is very much in the United States interest to ratify this treaty, even though, as in the case of every tax treaty, we do not have everything in the treaty that we might like. Yet, it is very much in our interest to ratify.

It is very much in our interest to continue working on the other problems to which you refer, some of which will fall in the tax area, but most of which frankly will not.

The CHAIRMAN. In the broadest context, I do consider this treaty an important one. Certainly even before President Reagan assumed office, in the meetings we had with him when he was President-elect, Canada and Mexico were the only two countries about which I spoke to him.

Since they are our neighbors, we should put the highest possible priority on them. I urged the President to visit them. Unfortunately, President Carter had never gone to Ottawa during his 4 years in office. I urged President Reagan to make an early visit there. He certainly has done that and it was a spectacular success.

I think the rapport established between the President and Prime Minister is good. Working relationships are very good between our

State Department and their Ministry of Exterior Affairs or Foreign Affairs. Even when we could not agree on the fisheries treaty in this committee, we singled out the boundary treaty and gave our advice and consent on that treaty.

This afternoon we will be receiving additional testimony on 10 other treaties pending before the committee. There have been some concerns expressed by Members of the Senate and House tax committees that tax treaties are being utilized to supercede provisions enacted in U.S. tax laws.

What would your response be to such criticism? Could you provide a list for the record of those provisions of the U.S. Tax Code which are preempted or affected by the various provisions of this treaty that is before us?

Mr. **Chapoton**. Yes; we would be happy to provide that list.

[The information referred to follows:]

Provisions of the Internal Revenue Code Overridden by the Tax Treaty

[SUBMITTED BY THE DEPARTMENT OF THE TREASURY]

The Internal Revenue Code specifically provides for the rules of tax treaties to take precedence over the rules of the Code (see sections 894 and 7852(d)) in cases where the results would be more favorable. In general, in tax treaties, including the Canadian treaty, those provisions of the Code which may be superseded by treaty rules are the provisions relating to the taxation of foreign persons resident in the treaty jurisdiction. For example, the statutory 30 percent withholding tax is reduced with respect to payments to Canadian residents to either 10 or 15 percent on dividends, to 15 percent on interest and to 10 percent on industrial royalties and zero on cultural royalties. The treaty also establishes somewhat higher thresholds than those in the Code for the U.S. taxation of the business profits of a company resident in Canada or of the personal service income of Canadian residents. In some respects, the treaty limits the right granted by the Code to tax gains of Canadian residents on U.S. real property. All of these concessions are reciprocal.

In general, U.S. tax treaties do not override Code provisions as they apply to U.S. citizens and residents. There are, however, some exceptions to this rule. All treaties provide a foreign tax credit to U.S. citizens and residents independent of the Code grant of a credit. In the Canadian treaty, the credit is limited on a per country basis so that if any of the Canadian taxes which are deemed to be creditable under the treaty would not be creditable taxes under the Code, such credit would be subject to a per country limit i.e., such taxes could not offset U.S. tax on third country income. Taxpayers, however, are free to use the Code overall limit with respect to any Canadian tax which is creditable under the Code.

The Canadian treaty also modifies rules of the Code for determining the source of income for purposes of the foreign tax credit. For example, a portion of what, under the Code, would be treated as U.S. source dividend and interest income of U.S. citizens resident in Canada may be treated as Canadian source under the treaty to the extent necessary to avoid double taxation.

The treaty also modifies the Code rules by allowing U.S. citizens and residents to treat contributions to certain Canadian charitable organizations, subject to limitation, as deductible charitable contributions.

Mr. **Chapoton**. My general reaction is, we are aware of those concerns and we certainly take such matters into account in the negotiation of treaties. But there is no question that when you negotiate tax treaties it is a give and take process, and indeed there are circumstances under which we forgo taxes and make concessions that are not otherwise provided in the code and the other country does likewise.

So it is a necessary process. I think the tax-writing committees, particularly on the House side, do feel left out of that process to some extent, because of the nature of the negotiating process and the ratification process. But we think by and large it works well.

By the way, we do consult closely with the staffs of the tax-writing committees in our treaty positions and in the explanations. We think by and large it is a good, workable process.

BENEFITS TO UNITED STATES

The CHAIRMAN. I mentioned in my opening statement some benefits that I see to the United States, and obviously it is Canada's job to emphasize to the Canadian Parliament the advantages to their country. It is our job to convince the Congress that this is a good thing for the United States.

How does this treaty specifically, in your own judgment, benefit the U.S. Government or U.S. business interests? Would you outline some of the provisions of the pending treaty which are an improvement over the 40-year-old treaty that is in effect right now? Which provisions are not an improvement?

Mr. CHAPOTON. When you start ticking off the list of improvements, the first you might mention is the reduction on withholding tax in Canada from 15 to 10 percent on dividends from subsidiary corporations. The reduction in the maximum rate on royalties that might be collected by Canada; the reduction in their so-called branch profits tax.

In addition, we coordinated the tax on capital gains between the two countries, and in fact will be taxing certain capital gains from Canadian residents in this country, where that was not done under the present treaty. We also will facilitate the claiming of tax credits by U.S. citizens who are resident in Canada, eliminating to a large extent the possibility of double taxation.

The other major element of this treaty is the so-called competent authority procedure to resolve controversies involving companies that are operating on both sides of the border. I am sure in your experience you will remember section 482 problems that can arise when you try to allocate income to one jurisdiction or another. Well, the rules are spelled out in detail in the proposed treaty which provides specifically how the competent authority mechanism will work.

As I mentioned in my statement, there are provisions for lengthening the statute of limitations.

The CHAIRMAN. As you know, we do have a lot of pressure in this country against foreign investment. It is a case of the left hand not knowing what the right hand is doing many times. I participated in Treasury Department exercises where we encourage foreigners to come over here. We tell them how good investment is in this country. We try to emphasize the necessity of recycling petrodollars.

And yet, pressure groups in this country resisted. Well, take Illinois as an example. We had an uproar during my campaign that Saudi Arabia might buy up all the farmland in Illinois. They wanted to put prohibitions and limitations on that.

I have fought all of my business life against limitations on the flow of capital. I certainly am not going to spend my time in public life trying to prevent it. In this case, the rumors and stories that were going around about the size of foreign investment, of what they were trying to do, were simply ridiculous.

In general, certainly between friendly countries, we should have as much flow as possible. But I was concerned when Canada, which has the sovereign right to do whatever it wants in handling its affairs, did establish the Foreign Investment Review Agency in 1973.

CANADIAN DISCRIMINATORY PRACTICES

And I wondered whether or not during the course of tax treaty negotiations with Canada there were discussions concerning Canadian discriminatory practices found in its national energy program or foreign investment review process. If you did not get into those areas, why not?

Mr. CHAPOTON. Mr. Chairman, let me check with one of the staff people who is here. But to my knowledge, those areas were not specifically addressed.

[Pause.]

Mr. CHAPOTON. I am advised that they were discussed, but, as might be expected, they really were considered by Canada to be outside the scope of the tax treaty. It is not our usual practice in negotiating a tax treaty to introduce such nontax-related items in our effort to prevent international double taxation and to remove the tax impediments from the free flow of capital, even though I have to concede major nontax elements do enter into tax treaties from time to time.

The CHAIRMAN. Well now, this is the Foreign Relations Committee. We are not trying to see the world just through tax treaty eyes. We are interested in the whole total relationship.

The reason I moved this hearing forward and held it months before we would have been able to schedule it is because I was concerned about our overall relationship with Canada. This seemed important to Canada. If it is important to Canada, it has be to important to us. So we moved it up on the front burner.

But if during the course of our conversation you can contribute a thought as seen by the participants in these negotiations in any of these areas, this committee would be interested in the broader aspect of it. When Secretary Haig comes in here, he thinks he is coming in to testify on one subject, but we have 17 Senators on our committee and they can broach any subject they want to hear about, which they think is important to the foreign policy of this country.

Certainly our relationship with Canada, as you see it, would be very important. I think the perspective of the State Department as well as your perspective would be very important. The State Department has worked throughout the months and years with Canada on these problems. If there is any information which you have which can shed some light on this, it would be in the best interest of Canada and the United States and our respective foreign policies to air them as much as you can.

Mr. CHAPOTON. Mr. Chairman, I understand your point and agree with it. I simply want to say that the tax law is so complicated in both jurisdictions that there is a tendency to confine the technical negotiations to those types of questions. But I do understand your point.

ADMINISTRATION'S GOAL AND OBJECTIVE

The **CHAIRMAN**. Before you firmly take the fifth on behalf of yourself and all of your colleagues——

[Laughter.]

The **CHAIRMAN** [continuing]. Let me encourage you to open up with the committee and with me particularly as much as you can in this area. That is the overriding concern that we have. We must have a very close working relationship with Canada. That is my goal and objective. Is it the President's goal and objective? Is it this administration's goal and objective?

To the degree that we can air out the issues, it would be helpful. We are both democratic republics and, while we both have sensitivities, we are used to having our problems aired and viewed. That is the great virtue and value of our type of society, and this kind of forum is a valuable forum to help educate me on certain aspects of the matter that you as an individual and your colleagues may have insights that you can share with us.

I would like to talk next about nondiscrimination. Canada's tax system contains a number of provisions that discriminate against foreign investors as opposed to Canadian investors. For example, Canadian corporations receive a surtax exemption if they are owned by Canadians, but not if they are owned by foreign persons. Likewise, Canadians are permitted to deduct expenses for advertising on Canadian TV stations, but not on U.S. stations. Certainly owners of television stations along the border are very unhappy about this.

Generally, a tax treaty contains a broad nondiscrimination provision that would prohibit Canada from discriminating against U.S. investors. The proposed treaty, however, while it does contain a nondiscrimination provision, would not prohibit all discrimination. Accordingly, the treaty countenances some discrimination.

First, should the United States enter into a treaty which specifically acknowledges the right of a developed country to discriminate against U.S. investors?

Mr. **CHAPOTON**. Mr. Chairman, we discussed that question at some length. As you point out, the Canadian treaty does permit some discrimination in favor of Canadian companies. It does, however, grant U.S. investors the assurance that they will not be treated more harshly by Canada than investors from any other country.

We strongly prefer full nondiscrimination. We do attempt to get it in every treaty. Canada has not been willing to give full nondiscrimination protection to any of its treaty partners. In this treaty we have the same protection or as good protection as any other treaty partner of Canada. We do not, however, have as much as we would like. We simply have to take that as part of the overall bargain, and we think on balance it is a good treaty. By itself, however, it is not a desirable provision.

The Canadian broadcast situation, we think is very unfair, there is no question about it. They have attempted to deny deductions and have attempted, obviously, to prevent spending money on advertising on U.S. radio and TV stations. We think they are making a mistake from their own standpoint as well as ours.

Suggestions have been made that we should do likewise and in effect deny U.S. taxpayers deductions for expenses of advertising on Canadian stations. We do not think that type of meat ax approach is the best approach. We are still attempting to persuade Canada to resolve this problem.

We do, however, have under consideration at Treasury a provision which would give greater authority to deal with such situations, both in Canada and in other countries where unfair provisions such as this are utilized.

RECIPROCITY IS IMPORTANT

The CHAIRMAN. In a relationship of two great sovereign countries such as ours, reciprocity is the important thing. We must take into account that what is good for the goose is good for the gander. We can always enter into a series of retaliatory actions. However, that is a losing proposition. In the end, when you initiate a discriminatory practices, it is generally the consumers of our own country who are deprived of free market opportunities and who pay the price. It is the special interest groups who wish to obtain a particular special advantage, to have things removed from the competitive market. The consumer pays for the privileged position which they seek.

I think we ought to work very hard to resolve this problem. If we cannot win this kind of a philosophical battle with Canada, we can not win them with anyone. And I would hate to see the United States and Canada enter into an increasingly bitter confrontation, as special interest groups on both sides try to cause us to twist and turn the marketplace for their particular advantage. Both countries must resist the temptation to escalate this difficult situation.

The nondiscrimination provision of this treaty is weaker than the provisions in most U.S. tax treaties. I would have thought it would be stronger. It is weaker. It is certainly much weaker than the OECD model treaty and the U.S. model tax treaty.

Why is this provision, the nondiscrimination provision, weaker in the Canadian treaty?

Mr. CHAPOTON. Let me state, Mr. Chairman, that you are of course correct. It is weaker in the case of Canada. It is simply the most they were willing to do. It is consistent with the treaties they have entered into with other countries, and they have been adamant on not giving more on this point. It is a matter of concern.

The CHAIRMAN. I share your concern and I want our friends in Canada to know that we share the administration's concern. I do not think it is in their best interest overall. It is not in ours, and it certainly is not in the interest of our mutual relationship.

NONDISCRIMINATION PRINCIPAL REASON FOR TAX TREATY

Mr. CHAPOTON. I would concur with that statement, Mr. Chairman, because we do feel nondiscrimination is one of the principal reasons for entering into a tax treaty. So the nondiscrimination rules affecting both countries should be very strong.

The CHAIRMAN. With respect to mineral royalties, the present treaty contains an overall 15-percent limit on the rate of tax that either country can impose on investment income paid to residents of the other country. The proposed treaty removes this overall limitation but replaces it with limitations on the level of source basis taxation—taxation in the country where the income is generated—on various types of investment income. There is, however, no limitation on taxation of mineral rents and royalties.

Accordingly, the Canadian tax in mineral royalties will be increased, as I understand it, to the 25 percent of gross Canadian statutory rate. The U.S. rate will increase to the statutory 30-percent rate. The United States will give a foreign tax credit for these Canadian taxes, which means that the U.S. Treasury will bear the cost of the increase in the mineral royalties tax, if our understanding of it is correct.

Does the U.S. model treaty contain a limitation on the rate of taxation of mineral rents and royalties?

Mr. CHAPOTON. No, sir. This is consistent with the U.S. model. I think the lower 15-percent rate can probably best be explained by the fact that the present treaty was negotiated so long ago.

The CHAIRMAN. Approximately how much will the U.S. Treasury lose through foreign tax credits for the increased Canadian mineral royalty tax?

Mr. CHAPOTON. We do not have an estimate on that, Mr. Chairman. As you point out, it depends on the availability of the credit. In some cases, the tax indeed might exceed our foreign tax credit limits, in which case the cost would be borne, not by the Treasury, but by the taxpayer.

For many treaties we do not have revenue figures. We do have some revenue figures on parts of this treaty, but we have not been able to determine the estimate on mineral royalties with any accuracy.

The CHAIRMAN. Would you advise the committee if it is possible at some future time and provide for the record an approximation of that amount?

Mr. CHAPOTON. Yes, sir, we will make an attempt to do that.

The CHAIRMAN. How much of this amount will be recovered by the increased U.S. tax rate?

Mr. CHAPOTON. By the tax credit?

The CHAIRMAN. By the increased tax rate.

Mr. CHAPOTON. We will provide that also, Mr. Chairman.

[The material referred to follows:]

REVENUE EFFECT OF THE INCREASE IN THE TAX ON RESOURCE ROYALTIES

[SUBMITTED BY THE DEPARTMENT OF THE TREASURY]

We have little data on which to base such an estimate. On the basis of very limited information, we judge that the increase in Canadian tax would be in the range of $10 to $15 million. Some portion of this amount, probably a major portion, will be reflected in reduced U.S. revenues through increased foreign tax credits. The remainder will represent a cost to the income recipients. This is substantially less than the revenue gain which we anticipate will flow from the reductions in Canadian withholding on other forms of income payments.

The increase in U.S. revenues resulting from the increase in the withholding tax on resource royalties paid to Canadian residents is estimated to be no more than $1 million.

U.S. REAL PROPERTY

The **Chairman**. With respect to real property, the proposed treaty contains special rules for Canadian residents investing in U.S. real property that would override to a limited degree provisions of Foreign Investment in U.S. Real Property Tax Act passed last year. The proposed treaty eliminates trade or business property from the U.S. real estate rules. It also gives Canadian investors a step-up in the basis of their property to the effective date of the new treaty, which results in smaller capital gains for tax purposes.

Congress, when it enacted the Foreign Investment in U.S. Real Property Tax Act, specifically decided against any relief for preenactment appreciation of U.S. real estate owned by foreign investors. Why should Canadian investors be given preferential treatment on a U.S. real estate investment, as compared with other foreign investors?

Mr. **Chapoton**. The thinking was when negotiating the treaty that if you do not have that type of transitional rule, Canadians simply would have to sell their U.S. real estate before the effective date of the treaty. So there would be no purpose served in not having such a rule. Their gains are now tax-free and all that would be required is a realization of those gains before this treaty were enacted.

The **Chairman**. Does the treaty expand the limitations on taxing real estate-related gains to protect U.S. investors in Canada from Canadian tax?

Mr. **Chapoton**. It is a reciprocal rule. Yes, both countries can tax residents of the other country on their real estate gains.

The **Chairman**. Fine.

BORDER BROADCASTING

Just for a moment, on the border broadcasting versus the convention tax, signals of U.S. television stations along the border are picked up and retransmitted by cable systems in Canada. Over the past 20 years this has led to extensive sales of advertising on U.S. stations to Canadian advertisers.

In 1976, in part to discourage this practice, the Canadian Government passed law C-58 prohibiting tax deductions of advertising expenses incurred in foreign media, and began deleting commercials from U.S. stations carried in Canada. After consultations with U.S. officials, Canada agreed to drop commercial deletions. However, the restrictive tax law has remained in effect.

The Canadian tax restriction has, according to estimates by U.S. stations, resulted in a loss of $15-$20 million a year of U.S. advertising revenues. In 1978, 15 U.S. border stations filed a complaint with the U.S. trade representative under section 301 of the Trade Act of 1974 alleging that the Canadian tax practice is discriminatory and constitutes an unfair trade practice.

In late 1980 the President having determined that the Canadian law as it relates to border broadcasting was an unreasonable practice, proposed legislation which would amend the Internal Revenue Code to counter this situation. The proposed bill would have denied a deduction for expenses of an advertisement placed with a foreign broadcast undertaken and directed primarily to a market in the

United States if a similar deduction was denied to advertisers in the country in question—so-called "mirror" legislation. Congress did not, however, act on this legislation last year.

Last year the U.S. stations sought to establish a linkage between Canada's discriminatory tax law and a provision of the treaty which would have permitted expenses incurred by Americans at conventions in Canada to be tax deductible. The stations demanded that as a quid pro quo for permitting deductibility of convention expenses in Canada, Canada should agree to a treaty provision which removed its restrictions on the deductibility of expenses of Canadian advertising on U.S. stations. The Canadians had been anxious to lift the restrictions on foreign conventions, since it was estimated that Canada suffered losses of some $100 million annually in convention revenues. However, since Congress passed domestic legislation to permit expenses incurred by Americans at conventions in Canada and Mexico to be tax deductible, the provision of the treaty has become less important to Canada and the U.S. stations have lost their leverage.

On a recent trip I took to Canada, I was greeted as soon as I walked into a large hotel with: It is wonderful to see you, Chuck. There were 120 conventioners from Chicago up there, spending their hard-earned American dollars in Canada. We all had a good time together.

Certainly the flow back and forth between our nations has been a good thing through the years, and nondeductibility of these convention expenses on either side is a source of concern. Did the Treasury Department in the course of negotiations attempt to link both the convention issue and the border broadcasting issue? Why did Treasury agree to the convention provisions without obtaining Canadian concessions on the border broadcasting issue?

Mr. CHAPOTON. Mr. Chairman, I am advised that the border broadcasting matter, for better or for worse, was pretty well excluded from the negotiations of the tax treaty, even though, of course, it was a tax matter. It came up, but it was considered nonnegotiable by Canada.

The CHAIRMAN. Was it excluded by Canada?

Mr. CHAPOTON. Yes, sir.

The CHAIRMAN. And we agreed to enter into negotiations where we were excluded from discussing a hot issue concerning U.S. citizens. What if we had excluded any discussion of deductibility of convention expenses?

Mr. CHAPOTON. Well, it was not a matter that normally would be covered in a tax treaty. It is a matter concerning how Canada treats its residents under its own taxes.

The CHAIRMAN. But it has an effect on us.

Mr. CHAPOTON. Yes, sir, it does have an effect on us.

The CHAIRMAN. Is this a buck that you are passing back to the State Department? Is this their business? I thought it was Treasury's business.

Mr. CHAPOTON. Oh, no, I do not mean to state that. I am merely reporting what took place in the negotiation. We at Treasury are very concerned about this issue, as I mentioned.

Indeed, we have on the drawing board a provision which would allow us flexibility to deal with situations where this type of discrimination occurs. In other words, it would take legislation. We would like to deal with it directly by responding to such situations with some type of—well, I hate to use the world "retaliation," but the effect would be approximately that.

As to the treaty, it was a matter of the way in which they treated their own residents. And while of course it is a concern of ours, it is not a concern which we could resolve in this treaty negotiaton.

The CHAIRMAN. I think it is rather unusual in a negotiation to be precluded from discussing a controversial issue. Consider something like Prime Minister Begin coming over here and saying, I want to talk about F-16's, but I do not want any discussion of AWACS as a part of it.

If we preclude ourselves from discusssing something that is in our interest to discuss before we enter into a negotiation, we do not have much of a chance of rectifying that problem.

When will we take up that particular grievance? Is that not the proper forum in which we should do it?

Mr. CHAPOTON. Well, no, the tax treaty is not necessarily the proper forum. It is a matter that has been discussed with Canada and, as I said, is a matter of concern to us. We do plan to come forward with the proposal, which would give the Secretary of the Treasury authority to deal in very specific terms with the border broadcasting problem.

I do share your concern on the right of another country to simply exclude items such as this from negotiations. But it came to the point where we believed that having a new treaty would be more beneficial.

The CHAIRMAN. I do not have any border broadcasters in my State. But I can assure you, if other members were here who do have some, this part of the discussion might take up the rest of the day and tomorrow as well, because it is an issue of serious concern.

In the past, border broadcasters urged the administration to prepare legislation which would amend the Tax Code to deny a deduction for expenses of an advertisement placed with a foreign broadcast which was undertaken and directed primarily to a market in the United States. This restriction would apply only if a similar deduction was denied to advertisers in the country in question.

Will the Reagan administration propose this so-called "mirror legislation"?

Mr. CHAPOTON. No, sir, the Treasury Department will not propose the mirror legislation per se. The proposal that I discussed earlier may give the Secretary of the Treasury, or actually the President, the authority to take action very similar to mirror action if deemed necessary.

The CHAIRMAN. In any way, will the ratification of this treaty prevent future legislation from linking once again the U.S. border broadcasting issue with the convention tax deduction issue?

Mr. CHAPOTON. The convention issue? This treaty would grant deductions for conventions in Canada. We could, in addition, subsequently amend internal law and deny the deduction. I would think, however, that is probably unlikely.

The CHAIRMAN. So that we can stay on schedule, Mr. Chapoton as we have other witnesses this morning, let me say that I very much appreciate your concise and to the point answers.

For the guidance of our other two panels, because I will be floor managing the foreign assistance bill shortly after noontime, my plan would be to complete this section of the hearing by 11 o'clock and provide roughly 25 minutes for each of the next two panels.

FOREIGN TAX CREDITS

We will submit questions for the record to you, Mr. Chapoton, and to our other panels, because I know the schedule is very tight. The final area in which I would like to question you is foreign tax credits. The U.S. foreign tax credit provided for by the treaty is to be applied on a per country basis, that is Canadian taxes will only be permitted to offset U.S. tax imposed on Canadian income. Also, the source rules will be applied on a per country basis. This contrasts with the code limitation, which is computed on an overall worldwide basis.

How will the two overlapping systems of the treaty and code be applied?

Mr. CHAPOTON. The per country limitation on the credit under the treaty applies specifically to taxes that would not be creditable absent the treaty. So we feel that a per country limitation on those taxes that would not be creditable under the code certainly is appropriate in this case.

There are questions, and this is the area which will be dealt with in the further explanation that I mentioned earlier. The further explanation will deal with the question of how that per country limitation applies to taxes, say, paid to a European country and how those taxes will be treated under the overall limit or the per country limit as a result of this treaty. We want to consider that question further.

The CHAIRMAN. The Department of the Treasury's technical explanation states that the Canadian general corporate tax will continue to be creditable even if Canada imposes a flat rate tax on natural resource income that is not deductible in computing the general corporate tax. At the time of negotiation that flat tax rate was expected to be only 8 percent.

Can you provide the committee with information as to how high this natural resources income tax is likely to be?

Mr. CHAPOTON. Well, that 8-percent tax, is going to 16 percent, and indeed we want to look at that situation to see if that has changed the nature of the tax and has affected its credibility.

The CHAIRMAN. Is this tax creditable for U.S. tax purposes?

Mr. CHAPOTON. Not the 16 percent, no, sir.

The Chairman. So it would not be, I see.

If this tax goes up significantly, as you have indicated it will, would it call into question the creditability of Canadian corporate taxes paid by Americans?

Mr. CHAPOTON. That is correct, yes, sir.

The CHAIRMAN. How does the proposed treaty resolve this issue?

Mr. CHAPOTON. The treaty does not resolve that issue. The treaty contemplates that so long as the corporate tax is substantially similar to the one in place at the time the treaty was negotiated, the tax is creditable. At that time the flat rate tax was supposed to be 8 percent, and it is now 16. That does call into question the creditability. We will have to deal with that.

EFFECT ON U.S. TAX REVENUE

The CHAIRMAN. What will be the net effect of this treaty on U.S. tax revenue? Will there be a net loss or gain?

Mr. CHAPOTON. We feel there will be a net gain. But as I mentioned earlier, we do not have specific figures on all aspects of the treaty. Mr. Chairman, that is not an overall consideration in the negotiation of tax treaties.

The CHAIRMAN. I want to thank you very much indeed for your appearance here this morning. In view of the fact that other members of the committee were not able to be here today and other points of view were not able to be brought out, I think it would be helpful to the committee if anyone who has a vital interest in this, pro or con, would communicate with the committee within the next few days. Would you give me the benefit of your views as to the desirability of ratification of this tax treaty.

We will move just as expeditiously as we possibly can on this, Mr. Secretary. Thank you for your appearance here today.

Mr. CHAPOTON. Thank you, Mr. Chairman.

The CHAIRMAN. Our first panel will consist of David H. Brockway, deputy chief of staff of the Joint Committee on Taxation, and Richard A. Gordon, international tax counsel of the Joint Committee on Taxation.

Gentlemen, we very much appreciate your being here. Would you give me an estimate as to about how long your statement would be?

STATEMENT OF RICHARD A. GORDON, INTERNATIONAL TAX COUNSEL, JOINT COMMITTEE ON TAXATION, ACCOMPANIED BY DAVID H. BROCKWAY, DEPUTY CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION, AND THOMAS JOYCE, ACCOUNTANT, JOINT COMMITTEE ON TAXATION

Mr. GORDON. Certainly, Mr. Chairman. My name is Richard Gordon and I am the International Tax Counsel to the Joint Committee on Taxation. I am accompanied by David Brockway on my left. He is our Deputy Chief of Staff and was our International Tax Counsel. On my right is Thomas Joyce, our staff accountant, who works extensively in the international area.

In light of the time constraints and your interest in hearing from public witnesses, we will be very brief. We already have submitted a number of documents for your consideration. As in the past, we have prepared a pamphlet that describes the treaty and the issues raised by it. We have also prepared issue papers, and we have a statement we would like to submit for the record.

We would just like to highlight a couple of the issues raised by this treaty, many of which you already have touched upon during Mr. Chapoton's testimony.

In preparing for these hearings, we have had extensive conversations with outside practitioners, with academics who are familiar with the international tax area, and with affected taxpayers. We have also consulted at length with the staff of the Foreign Relations Committee and with the Treasury Department.

I am not going to highlight all of the ways in which the proposed treaty improves upon the present treaty. Mr. Chapoton has already done that. We would like to point out, however, that the treaty does contain a number of provisions that will be helpful to both countries and to their residents.

We also have to keep in mind, as you yourself pointed out, that the treaty is a product of negotiation. We do have a treaty in place. We are not starting with a clean slate. Under the proposed treaty some taxpayers will be a little better off than they were before, and some taxpayers may not be as well off as they were before. This is all a result of the negotiations.

The first issue that should be brought to the committee's attention is that raised by the nondiscrimination provision in the treaty. This provision differs somewhat from the OECD and the normal U.S. models, in that it allows some tax discrimination by Canada against Canadian corporations which are owned by U.S. residents.

We understand from our discussions that this provision is the best provision that Canada has been willing to give to any of its treaty partners, and it certainly gives much broader protection than is given under the existing treaty.

There is some question as to the level of Canadian discrimination. It is very difficult to get a handle on because it is in a state of flux at this time, particularly with respect to the petroleum industry. Canada has recently announced some legislative and administrative initiatives in this area, and it is unclear exactly how the situation will develop.

The United States generally has taken the position that we should not permit discrimination by our treaty partners. However, we are beginning to enter into treaties with developing countries which, as a matter of policy will insist on at least some discrimination to encourage residents to invest in the country. Canada, we assume, would also like to encourage some internal development and internal ownership of its resources.

The committee could, of course, recommend that the treaty be rejected or that this nondiscrimination clause be reserved on, but this could result in a loss of the treaty and it would not, by itself, end the discrimination. As we said, we are unaware of any treaty in which Canada has gone quite this far.

The other issue that has been raised is the issue of the taxation of mineral royalties. Under the current treaty, the countries may tax mineral royalties at only 15 percent. Under the new treaty there would be no limit. This is of concern to some U.S. investors in Canada, as the rates there will go up to 25 percent. And I guess some people are concerned that the rates could go above 25 percent, and that I think would be a major concern.

It would have been possible, of course, to provide for a lengthier transition rule. It might have been possible to negotiate a limit that was substantially higher than the current limit, but would give comfort to some people. This committee, in its report to the Senate, could, of course, recommend that Treasury attempt to negotiate some cap on this taxation of mineral royalties. However, the treaty does conform with current international standards.

Another area of concern, is the real estate area. The treaty does create significant problems, and it has been of some concern to Members of Congress. It conflicts in a number of respects with the recently enacted U.S. real property legislation, for which there was quite a bit of public support because of the concern with foreign investment in U.S. real estate.

We would like to point out that the major provisions of that legislation are still intact. There is no restriction generally on United States taxation of Canadian investors in U.S. real property where they purchase that property after the effective date of the treaty.

One problem is that this treaty was negotiated before the legislation was enacted. It appears that some of the technical rules in the treaty were an attempt to conform the treaty to what Treasury thought the legislation might look like. However, the legislation came out somewhat differently.

The end result is that there are differences in details, and the committee may wish to suggest that the Canadian treaty be renegotiated or at least that Treasury approach the Canadians about possible amendment to the real estate provisions to conform them more closely to U.S. law. We do not know whether the Canadians would be agreeable to that, but if it is a sore point it may be that something could be worked out.

Some are also concerned with the foreign tax credit rules. Generally, if a tax is creditable under the Internal Revenue Code you never get to the treaty and the treaty is not important in that respect. However, where the creditability of a foreign tax is in question the treaty gives comfort to U.S. taxpayers and the treaty will provide for a credit, subject to whatever limitations are contained in the treaty.

In the treaty before you, there is a per country limitation under which the Canadian tax granted by the treaty could only be used to offset U.S. income taxes on Canadian income. One issue of some concern which came up in previous testimony is the question of the impact of Canada's proposed 16-percent petroleum tax on the underlying Canadian corporate tax.

The Treasury's technical explanation initially said that they understood that Canada was going to impose an 8-percent tax and that this would not affect the creditability of the underlying Canadian tax. Canada has now proposed a significantly higher tax and this does raise some questions and creates some uncertainty which the committee might want to see clarified in the course of its deliberations.

Another issue which has been raised is the foreign convention issue, which some have tied into the border broadcasting issue. To some degree the foreign convention issue is moot because of legislation enacted late last year, which permitted U.S. persons to take deductions for conventions in Canada.

The convention deduction, however, does raise a broader issue, which is the appropriate scope of U.S. tax treaties in general and whether they should be used to grant to U.S. people deductions. There is another provision in this treaty, a provision which is also in the present 1942 treaty, which raises the same issues. It gives U.S. persons and, reciprocally, Canadians deductions for contributions to charities in the other country.

The **Chairman**. Mr. Gordon, I have a few questions to ask of you. Is Mr. Brockway going to also give a statement?

Mr. **Brockway**. No, sir.

The **Chairman**. Very well, then. Why do you not finish up in 2 or 3 minutes, so that we have further time for the questions.

Mr. **Gordon**. We are about finished. I guess the only other issue of concern at this point is that the treaty does provide for Canadian pension plans to be able to invest in the United States free of tax on their dividends and interest. This is an issue because bills to this effect, which would permit all foreign pension plans to invest in the United States tax free, were introduced in the Congress last year. A number of British and Dutch pension plans have expressed an interest in this investment.

I guess giving it here, even to a limited degree, might put some pressure on Treasury to negotiate similar treatment elsewhere or put some pressure on a legislative solution. But this is something else that the committee may want to take into account in its deliberations.

That concludes our statement and we would be pleased to answer any questions.

[Mr. Gordon's prepared statement follows:]

Prepared Statement of Richard A. Gordon

INTRODUCTION

It is our pleasure to appear before you to provide staff assistance on the Canadian tax treaty currently under consideration by your Committee. As in the past, our staff has prepared a pamphlet on the treaty before you. This pamphlet gives an article-by-article description of the treaty and generally indicates those provisions which differ significantly from those normally found in United States tax treaties. The introduction to the pamphlet highlights the provisions of the proposed treaty which present significant policy issues. In addition, we have prepared a brief memorandum summarizing some of the issues raised by the various tax treaties before the Committee, including this one.

In preparing for this hearing, staff discussed the treaty with a number of affected taxpayers' tax lawyers, accountants, and academics with expertise in the area. We spoke with former government officials who participated in the negotiations. We worked closely with the Treasury and with the staff of the Foreign Relations Committee in those efforts.

Our remarks this morning are directed solely to the proposed treaty with Canada. In the hearings to be held this afternoon we will address some more general issues.

Importance of ratification

The proposed treaty with Canada deals with many issues that have arisen over a number of years. The present treaty, as amended, is almost 40 years old and does not adequately address the current economic relationships between Canada and the United States. Canada is our most important trading and investment partner. Also, its physical proximity and the general language and background similarity between the two countries make the personal relationships between the two countries among our closest. The proposed treaty contains a number of provisions that reflect these close personal and economic contacts. For example, it solves some problems of concern to persons who move between the two countries, and permits a deduction to residents of the one country for charitable contributions to universities in the other country which they or their family attended. It contains rules that may help to settle disputes as to the residence of persons who move from one country to the other for short periods of time. It provides and coordinates rules relating to taxation of capital gains. It solves some problems involving corporate reorganizations, and it improves the administrative provisions in the present treaty.

Also, among the very significant benefits provided to United States taxpayers under the pending treaty is a reduction in dividend withholding rates from the present 15 percent to 10 percent if the recipient owns 10 percent of the voting stock of the paying corporation. Furthermore, when compared to the existing treaty, the proposed treaty contains significantly expanded protection for United States taxpayers against discrimination by Canada.

It some cases, a particular taxpayer or industry receives better treatment under the present treaty than under the proposed treaty. Since the treaty is essentially a compromise between the conflicting interests of the two countries which have changed in a variety of respects since the present treaty was entered into, that result is not unexpected. The central issue is whether the final agreement represents a bargain which is sufficiently favorable overall to the United States that it should be ratified.

The proposed treaty was under negotiation for approximately six years. We have talked with a number of former Treasury officials involved in the negotiation process. They generally believe that the treaty is the most favorable result they could expect on a number of the important points such as nondiscrimination and the withholding rate on dividends. In general, they believe the treaty to be a good one and a vast improvement over the present treaty.

For a number of reasons, the pressure from Canadian business groups to agree to a new treaty may be less substantial than for the United States. One is that there is more United States investment in Canada than Canadian investment in the United States. Accordingly, the larger share of the benefits of the reduction in source taxation of direct investment dividends accrues to the United States taxpayers. Thus the reduction in the withholding tax on direct investment dividends from the present 15 percent to 10 percent in the proposed treaty is a significant concession by Canada.

Even for those Canadian businesses investing in the United States, the proposed reduction in the United States tax on dividends paid by United States subsidiaries to Canadian parent companies apparently is not that significant because much of that investment is routed through the Netherlands. This is due to a form of treaty shopping by which many Canadian direct investors may be able to receive dividends from the United States at the 5-percent tax rate provided for in the treaty between the United States and the Netherlands. [See, for example, the amended offer to purchase common stock of Hobart Corporation by CPE Acquisition Co., a wholly owned subsidiary of Canadian Pacific Enterprises (U.S.) Inc., February 6, 1981; pages 49 and 50 attached as exhibit.]

Discussed below are the significant issues that were brought to our attention in the course of our analysis of the treaty and discussions with outside persons, other staff and staff from the Treasury.

Issues

Nondiscrimination.—The United States generally insists that its tax treaties contain a broad nondiscrimination provision that would prohibit the treaty partner from discriminating against United States investors. At the insistence of Canada, the nondiscrimination provision in the proposed treaty is not as comprehensive as that sought by the United States or as that contained in the United States or the OECD Model treaties or the United Nations Model. On the other hand, the nondiscrimination provision in the proposed treaty is much broader than that contained in the present Canadian treaty which only applies to individual United States citizens resident in Canada. We understand that the provision is the broadest agreed to by Canada in any of its treaties. We also understand that a number of United States negotiators generally believe that Canada simply would not agree to a broader provision.

The area of concern is the treatment of Canadian corporations owned by U.S. shareholders. The U.S. model would prohibit Canada from taxing that Canadian corporation any less favorably than a similarly situated Canadian corporation owned by Canadian shareholders. In contrast, the proposed treaty only prohibits Canada from taxing a Canadian corporation owned by United States interests less favorably than a Canadian company owned by residents of any third country. For example, a Canadian company owned by United States residents cannot be taxed in a more burdensome manner than a Canadian company owned, for example, by a Swiss resident is required to be treated under the Swiss-Canadian income tax treaty. However, a Canadian subsidiary of a United States company can be taxed in a more burdensome manner than a Canadian company owned by Canadians. In effect, the United States is given most favored nation status. The present treaty does not provide for such most favored nation treatment.

Staff understands that the Canadian tax system contains several features that discriminate against foreign owned Canadian companies. A number of these involve Canadian taxation of natural resources. However, the situation is in a state of flux and is thus difficult to analyze. One particular area of concern is Canada's rules that provide incentives to natural resources exploration that are available only to Canadian controlled companies.

Some might question the wisdom of entering into a treaty with a developed country that permits a broad form of discrimination. Such a provision might be viewed as precedent for future negotiations particularly with developing countries that tend to want to discriminate to encourage local ownership of resources. Furthermore, it has been the long-standing policy of the United States not to agree to discriminatory treatment. The discriminatory treatment permitted here is prohibited by the OECD model convention. See Article 24(b). Canada reserved its position on the entire article. Commentary on the Articles of the OECD model Convention, Article 24, paragraph 61, pg. 174.

On the other hand, our discussions have given us little reason to doubt that Canada is unlikely to grant nondiscrimination protection to United States controlled Canadian companies. For example, it is stated Canadian policy to encourage Canadian ownership through its Petroleum Incentives Program.

It should be noted that the treaty leaves open the option for the United States Government to retaliate against this discrimination by increasing the United States income tax on United States corporations owned by Canadians under the anti-discrimination provisions of the Internal Revenue Code (sec. 896). However, there is more United States investment in Canada than Canadian investment in the United States which would limit the impact of retaliation. Moreover, it is not clear that the anti-discrimination provision gives the President the authority to increase taxes of United States companies even if they are owned by residents of a country which discriminates against U.S. investors.

If the Committee decides that discrimination presents sufficiently troublesome problems, it could, of course, recommend that the treaty be rejected. However, rejection of the treaty will not by itself end the discrimination by Canadians against United States owned Canadian companies.

If the Committee decides that the potential for discrimination by the Canadians is sufficiently troublesome, it could recommend the adoption of the treaty subject to a reservation on the Nondiscrimination Article (Article XXV) to the extent that it permits this discrimination. It must be emphasized, however, that Canada most likely would refuse to ratify the treaty subject to such a reservation.

Alternatively, if the Committee does not want to take either of the above actions because it feels that the treaty is sufficiently important that it should be ratified notwithstanding any problems presented by the nondiscrimination provisions, the Committee may wish to include a statement in its recommendations emphasizing its concern and urging the Treasury to resist strenuously similar provisions in future treaties. It may, however, wish to distinguish between developed and developing countries for this purpose.

Natural resource income.—The present treaty contains an overall 15-percent limit on the rate of tax that either country can impose on investment income paid to residents of the other country. The proposed treaty removes this overall limitation but replaces it with limitations on the level of source basis taxation of various types of investment income. However, mineral rents and royalties are income from real property which under the real property article (Article VI) may be taxed without limit by the country of source. Accordingly, the Canadian tax on mineral royalties will be increased to the 25 percent of gross Canadian statutory rate. The United States rate will increase to the statutory 30-percent rate. The proposed treaty contains a transition rule that will keep the lower 15 percent rate for one additional year only.

The provision will primarily affect United States persons who receive royalty income from natural resource operations in Canada. There are, however, Canadian royalty interests in United States resources and the United States Treasury will increase its revenues in those cases.

The exclusion of mineral royalties from any treaty limitation on the level of withholding taxes is consistent with present United States treaty policy and the OECD model convention. It is consistent with most current United States tax treaties and all of those currently before this Committee.

Affected United States taxpayers have argued that investments were made taking into account the 15-percent limit in the current treaty, and raising the tax on the royalties from that investment could make them noneconomic. Also, some have expressed concern that once the present treaty is approved Canada will issue its tax on increased rents and royalties, perhaps significantly

It would be difficult to recommend a reservation, or rejection of the treaty, because of a provision that reflects current United States and international standards. However, we are not starting from scratch, and thus certain alternatives could be considered. One would be to grandfather existing mineral interests by giving them the current 15-percent rate. Another would be to have a longer transitional period followed by a phase out of the limitation. This would give investors time to adjust. An alternative would be to provide a much higher limit, for example 25 or 30 percent, which would permit Canada to increase the tax burden on United States mineral resource investors, but would give some comfort to United States investors against greatly increased Canadian taxation.

If the Committee decides that this issue is serious enough to warrant action it could, of course, recommend a reservation along the lines of one of the above alternatives. Alternatively, it could recommend ratification without reservation on this point but include a statement in its report instructing the Treasury to attempt to negotiate relief for United States mineral investors.

Benefits under Canadian integrated tax system.—In 1972, Canada introduced a new system of taxing income from corporations which partially combines or integrates the tax paid by the corporation on its earnings with any tax paid by the shareholder with respect to distributions from the corporation.

Under the Canadian system, a Canadian corporation pays tax at the normal rates whether or not the earnings are distributed. At the shareholder level, shareholders who are Canadian residents include the dividend in their income and also "gross-up" the dividend by an amount equal to 50 percent of the dividend. That is, the shareholder reports as income the dividend plus an amount equal to 50 percent of the dividend. The shareholders may then credit an amount approximately equal to the gross-up against his tax otherwise due. The credit offsets both Canadian and provincial tax to reach this result. Unlike some other systems, no cash refund is made if the credit exceeds the taxpayer's total Canadian tax liability.

The intent of this system is to partially relieve double taxation of distributed corporate profits. At times, the effect can be the total elimination of Canadian tax on dividends. Nonresident shareholders do not get the imputation credit. Accordingly, nonresident shareholders may be subject to a higher combined corporate and personal tax than a Canadian would be.

Relief is granted to United States shareholders by United States treaties with France and the United Kingdom, both of whom also have partially integrated corporate tax systems. In those two treaties, the relief takes the form of a refund to the U.S. shareholder of the appropriate amount of tax paid at the corporate level. In the proposed Canadian treaty, no such refund to U.S. shareholding is provided. However, at least partial relief is granted by the limitation on dividend withholding taxes. It should also be noted that under Canadian law, a nonresident shareholder does not "gross-up" his dividend from a Canadian corporation by the amount of the computation credit. Accordingly, the amount of the U.S. shareholder's taxable dividend is lower than that of a Canadian shareholder.

The Canadian situation is distinguishable in certain respects from that with the United Kingdom and France. The French relief is limited in that it applies only to portfolio investment. Both France and the United Kingdom have generally extended relief to investors from other countries comparable to that extended U.S. investors. The policies of the United Kingdom and Canada are different. The United Kingdom has traditionally welcomed United States investors and the granting of imputation relief is consistent with that philosophy.

In contracts, the Canadians have refused to extend the imputation credit in their treaties. The Canadians are not seeking United States investors in their industries. Also, Canadians have made what they consider to be a significant concession to the United States in lowering the dividend withholding rate at source to 10 percent from the present 15 percent.

Some concern has been expressed that the treaty without specific relief of U.S. shareholders will be precedent for negotiations with other countries, particularly Germany.

If the Committee considered relief for United States shareholders under imputation systems important, it could urge the Treasury not to agree to future treaties without such relief, at the least with certain countries. However, this could tie Treasury's hands and preclude future treaties that on balance may be in the United States national interest.

Canadian investment in United States real property.—The proposed treaty also contains certain provisions that would limit the United States taxation of Canadian investment in United States real estate provided for in the Foreign Investment in United States Real Property Tax Act that was enacted at the end of 1980. As these changes reflect departures from clear policy decisions made by the Congress, we would like to discuss them with you.

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to United States tax unless the gain is effectively connected with the conduct of a United States trade or business or, in the case of a nonresident alien, he is physically present in the United States for at least 183 days in the taxable year. However, under the Foreign Investment in Real Property Tax Act of 1980, as amended, a nonresident alien or foreign corporation is taxed by the United States on gain from the sale of a United States real property interest as if the gain was effectively connected with a trade or business conducted in the United States. Under the legislation, foreign persons selling stock in a United States corporation having 50 percent or more of its gross assets value comprised of United States real property interests are subject to United States tax on the gain.

The Act generally applies to tax the gain on sale made after June 18, 1980. The legislation specifically overrode real estate rules in existing treaties if those rules conflicted with its provisions. However, the legislation did not apply in those cases until January 1, 1985.

The present treaty contains a reciprocal exemption from tax for gains from the disposition of real estate. Accordingly, under the present treaty, Canadian and United States residents could continue to sell property located in the other country free of local source country tax.

The real estate provision of Article XIII of the proposed treaty generally would not restrict the right of the United States to tax the gain from the sale of United States real estate directly held by Canadian investors. It also retains the right of the United States to impose relevant reporting or withholding requirements. However, the right of the United States to tax Canadian investors under the legislation on the sales of their interests in United States real estate is limited in several respects described in Article XIII.

First, under the legislation a foreign investor is taxed on his entire gain realized on the sale of United States real estate regardless of when purchased. Congress decided not to give a step-up in basis (or fresh start) to fair market value as of the effective date of the legislation. Under the proposed treaty, however, gain would in effect only be taxable to the extent it occurred after the treaty goes into force. Taxpayers can show the actual amount of appreciation or use a monthly proration rule.

Second, for purposes of determining whether a corporation is a United States real property holding company, the legislation takes into account all real estate held by the corporation, regardless of whether it is held for use in a business. However, under the treaty, in determining whether an entity's assets consist principally of real property (the Treasury's technical explanation indicates that "principally" means more than 50 percent), business property (other than mines, oil or gas wells, rental property or property used for agriculture or forestry) is not treated as real property. Since it would remain an asset of the corporation, however, it means that the entity might be able to make significant nonbusiness real estate investments in addition to business-related U.S. real estate investments before exceeding the 50 percent test.

Third, the proposed treaty had an entity rule for partnerships, trusts, and estates under which gain from the disposition of an entity would not be taxed unless its assets consisted principally of United States real estate. The Code uses a flow-through rule for partnerships and a foreign investor who sells an interest in a partnership owning United States real estate would be taxed on the portion of the gain attributable to the real estate. Accordingly, Canadian investors could be at an advantage as compared to others. Also, this different system creates additional complexities.

Fourth, under the proposed treaty, the gain realized by a Canadian resident from the sale of a U.S. real property holding company is taxable by the United States only if the resident owns 10 percent or more of the stock of the company. Under the Code, the gain is taxable in the case of a publicly traded corporation if the shareholder owns 5 percent and without any minimum percentage holding limitation in the case of a privately held U.S. real property holding corporation. The use of a different standard for determining whether a Canadian investor so considered to be taxable would also create various uncertainties as to the application of many of the rules in the real estate legislation.

Finally, the treaty also includes a provision that would permit one country to tax gains from dispositions of interests in entities owning real property only to the extent that the other country would tax those gains. It is not at all clear why this provision is included in the proposed treaty. It would appear that by operation of this rule, Canada could change the U.S. taxation of Canadian investors merely by changing its real estate legislation (and vice versa).

A few observations are in order with respect to these provisions.

First, these limitations could be substantial in terms of revenue or numbers of affected taxapayers.

Second, the present treaty exempts capital gains from tax and without the proposed treaty this situation would continue until 1985. If ratified this year, the proposed treaty would come into effect as of January 1, 1982, and, under the transitional rule, would generally permit the United States to tax gain realized by Canadians who sell United States real estate on and after January 1, 1983. However, if the proposed treaty is not approved, the real estate legislation would be effective without limitation by the provisions of the proposed treaty discussed above.

Third, the provisions are reciprocal. They will operate to protect U.S. investors from Canadian tax on investments in Canadian real property holding companies just as they will operate to protect Canadian investors form U.S. tax on investments in U.S. real property holding companies. It should be noted, however, that the fresh-start basis provided in the treaty will principally be of benefit to Canadian investors in U.S. real estate because the Canadian capital gains tax has a general fresh start as of 1975.

The provisions raise no serious questions as to the conflict between United States tax policy and treaty policy. Of special concern here is specificity with which particular Congressional decisions are being changed shortly after enactment. If there is sufficient concern, the Committee may wish to approve the treaty subject to the limitation that the legislation will prevail over the treaty with respect to some or all of these conflicts. Alternatively, clear indications might be given the Treasury Department that the real estate legislation should not be overridden in future treaties.

Exempt organizations.—Unlike other United States tax treaties, the proposed treaty would exempt charitable organizations of either country from tax imposed by the other to the extent they are exempt in their home country. In addition, Canadian private foundations which receive substantially all their support from non-United States persons would be exempt from the 4-percent United States excise tax on income of private foundations. An exemption is also provided for pension funds but the exemption is limited to interest and dividends received from sources within the other country. Accordingly, Canadian pension funds could invest in debt obligations of United States persons and stock of United States corporations free of tax.

It is our understanding that this provision represents a concession primarily to Canadian charities and pension funds. The Committee should be aware that bills were introduced in both Houses of the last Congress and have been introduced in this Congress (S. 502—Messrs. Moynihan and Wallop) and H.R. 3056 (Messrs. Conable and Jenkins) that would grant an even broader exemption to foreign pension plans. Last year's bills were not reported out of Committee. United Kingdom and Dutch pension plans have expressed an interest in the exemption. It can be anticipated that approval of this provision in this treaty will encourage them to seek similar relief.

Foreign tax credit.—The proposed treaty specifically provides that taxes paid under Canada's general corporate income tax system are creditable income taxes under the treaty. However, the proposed treaty only requires the United States to allow the credit under the treaty for the Canadian taxes imposed on Canadian source income. The treaty thus imposes a per country limitation on credits for the Canadian taxes. This is in contrast to the Code overall or worldwide limitation. The treaty also superimposes the special Code limitations (for example, the oil related limitation) on the per country limitation. It should be noted that the additional per country limitation only applies if the taxpayer is claiming benefits under the treaty not creditable under the Code; that is, claiming as Canadian source income which could be treated as United States source under the Code.

The proposed treaty also contains a provision generally found in United States income tax treaties to the effect that it will apply to substantially similar taxes which either country may subsequently impose. It also contains a provision that it will apply to taxes on capital that either country may later impose.

In general, for most taxpayers there appears to be little doubt that the taxes described as creditable under the treaty are creditable in any event. The only significant question as to the creditability under the Code rules of any of the Canadian taxes covered by the treaty appears to be confined to the Canadian corporate tax as it is imposed on income from the exploitation of natural resource companies are subject to certain special rules which deny them certain deductions in computing their Canadian general corporate tax. The denial of these deductions creates some uncertainty as to whether the tax as imposed on such income qualifies for a foreign tax credit under the Code.

While the proposed treaty would resolve the doubt as to the creditability of the Canadian corporate tax as presently imposed on natural resource income, that treaty credit only applies if Canada does not make substantial changes in the tax. It is understood that the Treasury and the Government of Canada agreed that the general Canadian corporate tax would be considered a substantially similar tax for this purpose if Canada were to enact a low flat-rate tax on natural resource revenues even if that tax were not deductible in computing income under the general rules of Part I of the Canadian Income Tax Act. The Treasury technical explanation indicates that an 8-percent tax on oil and gas production revenues would be consistent with this understanding. It is now understood that the tax may be substantially higher; it may be as high as 16 percent. This leaves unclear the effect of the understanding described in the technical explanation.

Even if the new tax does not throw into question the credit under the treaty, some might question the policy of determining an income tax to be creditable before the Internal Revenue Service has ruled formally on the issue. Further, it could be argued that these determinations should be solely a matter of tax policy and thus should only be determined by the Internal Revenue Service through its normal administrative processes and ultimately by the courts. In this particular case, however, it can also be argued that the economic substance of the tax is sufficiently comparable to United States notions of what constitutes an income tax even with a higher gross receipts tax that it does not require a major departure from applicable tax policy principles to treat the Canadian tax as a creditable tax. Thus, the treaty in this case can be viewed as merely overcoming any possible technical obstacles to the creditability of the Canadian tax under the Code rules.

The proposed treaty would be the third treaty to contain a per country limitation on credit allowed for taxes which would not otherwise qualify for the credit under the Code. This appears to be included because the Treasury's outstanding temporary and proposed regulations defining the foreign tax credit throw certain petroleum taxes into question, and, more importantly, cast doubt on the underlying corporate tax systems as they apply to mineral resource companies. This is consistent with the Senate's reservation on the U.K. treaty. Once again, however, a question is raised as to whether a unilateral legislative solution to the problems involved in the credit for foreign oil taxes might not be ultimately more appropriate than attempting to deal with this problem on a country-by-country basis through bilateral agreement.

Allowance of deductions to United States persons.—The proposed treaty contains two provisions that give United States taxpayers deductions not permitted under the Code. This represents an expansion of general treaty policy, although one of the provisions, the allowance (on a reciprocal basis) of charitable deductions for contributions to Canadian charities is in the present treaty.

The proposed treaty contains a provision that would permit United States persons to deduct expenses incurred in attending business conventions in Canada. At the time this provision was negotiated, deductions for conventions held in all foreign countries, including Canada, were subject to substantial restrictions pursuant to amendments to the Code made by the 1976 Act. However, the Code was amended in 1980 to permit deductions for conventions in Canada and Mexico on the same basis as those held in the United States and its possessions. Accordingly, the treaty provision would no longer have any impact on United States taxpayers attending Canadian conventions. Unless a contrary intention is expressed by the Senate, however, the inclusion of this provision in the treaty could be taken as precedent for other negotiations. (The Jamaican protocol to be discussed this afternoon, also contains a convention provision.) It should be noted that Canada also has statutory provisions denying Canadian taxpayers deductions for attending foreign business conventions, so the principal impact of the provision is to allow Canadians deductions for Canadian tax purposes for attending business conventions in the United States.

The proposed treaty also permits United States persons a deduction for contributions to Canadian charities and Canadian persons a contribution to United States charities. This provision is also in the present treaty.

It has been argued that treaties should not be used to grant deductions to United States persons because they are not necessary to limit double taxation. On the other hand, the special relationship between the United States and Canada may warrant special rules in this case.

[Exhibit]

AMENDED OFFER TO PURCHASE FOR CASH ALL SHARES OF COMMON STOCK OF HOBART CORP. BY CPE ACQUISITION CO.

(A Wholly Owned Subsidiary of Canadian Pacific Enterprises (U.S.) Inc.) at $32.50 Per Share Net

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THE OFFER WILL EXPIRE AT 12:01 A.M., NEW YORK CITY TIME, ON SATURDAY, FEBRUARY 21, 1981, UNLESS EXTENDED

IMPORTANT

Any shareholder desiring to tender all or any portion of his Shares should (1) complete and sign the Letter of Transmittal or a facsimile copy in accordance with the instructions in the Letter of Transmittal and mail or deliver it with his stock certificate(s) and any other required documents to the Depositary or the Forwarding Agent or (2) request his broker, dealer, bank or other nominee to effect the transaction for him. A shareholder having Shares registered in the name of a broker, dealer, bank or other nominee must contact his broker, dealer, bank or other nominee if he desires to tender such Shares.

Questions and requests for assistance or for additional copies of the Offer to Purchase and the Letter of Transmittal may be directed to Georgeson & Co., Inc., the Information Agent, or to the Dealer Manager.

The Dealer Manager for the Offer is: The First Boston Corp., February 6, 1981.

Except as otherwise stated herein, the information concerning the Company contained herein (including, without limitation, Appendix I) has been taken from or based upon publicly available documents and records on file with the Commission and other publicly available information. Although the Purchaser does not have any knowledge that would indicate that any statement or information contained herein based on such documents and records is untrue, the Purchaser does not take responsibility for the accuracy or completeness of the information concerning the Company contained in such documents and records, or for any failure by the Company to disclose events which may have occurred and may affect the significance or accuracy of any such information but which are unknown to the management of the Purchaser.

9. *Certain Information Concerning the Purchaser, Enterprises (U.S.) and Certain Affiliates of Enterprises (U.S.).*—The Purchaser, a Delaware corporation and a wholly owned subsidiary of Enterprises (U.S.), was incorporated on December 10, 1980 for the purpose of acquiring Shares pursuant to the Offer and to date has engaged in no other business. The Purchaser's principal executive offices are located at Suite 1550, One Lincoln Center, Syracuse, New York 13202.

Enterprises (U.S.), a Delaware corporation with its principal executive offices located at Suite 1550, One Lincoln Center, Syracuse, New York 13202, was incorporated in 1978 as Canellus Incorporated and changed to its present name on December 11, 1980. Enterprises (U.S.) is a holding company and is subject to those corporate taxes to which United States corporations are normally subject. As a holding company, Enterprises (U.S.) oversees but does not become involved in the day-to-day operations of its subsidiaries. Its subsidiaries report to it on a regular basis and these reports are consolidated by Enterprises (U.S.) and forwarded on to Enterprises. The subsidiaries of Enterprises (U.S.), Baker Commodities, Inc., Processed Minerals Incorporated and Syracuse China Corporation, operate in the business of agriproducts, minerals and commercial china. These businesses are affected by general business conditions, and in the case of Baker Commodities, Inc., by the volatility of the market for agricultural products, particularly tallow, and in the case of Processed Minerals Incorporated, by the volatility of the market for salt. Set forth in Appendix II are the audited financial statements of Enterprises (U.S.) for the fiscal years ended December 31, 1979 and 1978 and the unaudited financial statements of Enterprises (U.S.) for the nine-month periods ended September 30, 1980 and 1979. While the audit of the financial statements for the fiscal year ended December 31, 1980 has not been completed, preliminary indications are that the net income of Enterprises (U.S.) for the fiscal year ended December 31, 1980 will be less than the net income of Enterprises (U.S.) for the fiscal year ended December 31, 1979. Enterprises (U.S.) believes that this decline is due principally to the effect of the factors described above.

Enterprises and certain of its affiliates continuously have under consideration various projects which if pursued would require additional capital. When such projects have been undertaken in the past, it has not been the practice of Enterprises to alter its policy concerning payment of dividends to it by its subsidiaries in order to obtain the necessary additional capital, nor have such projects had a material financial impact on the operations of Enterprises or its affiliates or subsidiaries (including Enterprises (U.S.)).

Enterprises (U.S.) is wholly owned by Canellus International B.V. ("B.V."), a holding company incorporated in The Netherlands in 1978, with its principal offices located at Seattleweg 7, Rotterdam, The Netherlands. B.V. was incorporated by Canadian Pacific Enterprises Limited ("Enterprises") as a holding company for the purpose of (i) acquiring, either directly or indirectly, other businesses and (ii) centralizing all non-Canadian holdings of Enterprises in one entity in order to maintain efficient control over an expanding volume of non-Canadian holdings. Certain tax advantages also may be obtained as a result of B.V. having been incorporated in The Netherlands. Pursuant to a tax treaty between the United States and The Netherlands, the withholding tax on a dividend paid by a corporation incorporated in the United States in respect of shares owned by a corporation incorporated in The Netherlands (assuming the ownership of 25 percent or more of such shares) is generally 5 percent of the amount of the dividend. The rate of the withholding tax which is payable on dividends of a United States corporation paid in respect of shares owned by a Canadian corporation is 15 percent (although if a treaty that has been signed by Canada and the United States becomes operative (and assuming the ownership exceeds 10 percent of such shares) this rate would be reduced to 10 percent).

All of the outstanding stock of B.V. is owned by Enterprises, a Canadian corporation having its principal executive offices at Suite 1900, Place du Canada, Montreal, Quebec, Canada H3B 2N2. Enterprises, incorporated under the laws of Canada in 1962, conducts a diversified international business through subsidiaries operating principally in Canada and the United States. Enterprises, through its subsidiaries, is engaged in the exploration for and the production of oil, natural gas and related hydrocarbons; is a major producer of zinc and lead and a producer of other metals and minerals; manufactures and sells pulp and paper, building products and lumber; produces iron, steel and steel products; manufactures commercial and industrial equipment and machinery and engages in engineering and construction activities; owns, manages and develops commercial and industrial real estate; processes and markets food and agricultural products; is engaged in the insurance of commercial and industrial risks; holds an investment portfolio; and is engaged in other businesses, including hotel operations. Enterprises is a management company which expects its subsidiaries to operate their own businesses. Its subsidiaries report to it on a regular basis. Enterprises provides economic and financial advice for its subsidiaries but does not become involved in their day-to-day operations. Certain of Enterprises' United States operations are carried on by the subsidiaries of Enterprises (U.S.). Enterprises' common shares are listed on the Montreal, Toronto, Vancouver and other stock exchanges as well as the NYSE. In the fiscal year ended December 31, 1979, Enterprises had consolidated revenues of $5,333 million and consolidated net income of $420 million and at that date had consolidated shareholders' equity of $1,907 million, all as stated in Canadian dollars.

Approximately 71 percent of Enterprises' common shares are owned by CPL. CPL, incorporated under the laws of Canada in 1881, with its principal executive offices at 910 Peel Street, P.O. Box 6042, Station A, Montreal, Quebec, Canada H3C 3E4, directly and through subsidiaries, carries on transportation and related rail, trucking, shipping, airline and telecommunication enterprises. The ordinary stock and certain other securities of CPL are listed on the NYSE and other stock exchanges. In the fiscal year ended December 31, 1979, CPL (including its interest in Enterprises) had consolidated revenues of $8,388 million and consolidated net income of $508 million and at that date had consolidated shareholders' equity of $2,988 million, all as stated in Canadian dollars.

CPL and Enterprises, since June, 1980, have been subject to the informational filing requirements of the Exchange Act and in accordance therewith file reports and other information with the Commission relating to their business, financial statements and other matters. Information, as of particular dates, concerning CPL's and Enterprises' directors and officers, their remuneration, options granted to them, the principal holders of CPL's and Enterprises' securities and any material interest of such persons in transactions with CPL and Enterprises is disclosed in materials filed with the Commission. Such reports and other information may be inspected, and copies may be obtained at the offices of the Commission and the NYSE, in the same manner as set forth with respect to the Company in Section 8.

The name, citizenship, business address and principal occupation or employment of each of the executive officers and directors of the Purchaser, Enterprises (U.S.), Enterprises and CPL are set forth in Schedules A, B, C and D hereto, respectively.

Mr. James M. Andreoli, a director of Enterprises (U.S.), owns 1,000 Shares that he purchased on January 24, 1980. On Decemnber 10, 1980, 100 Shares were purchased in the open market on behalf of the Purchaser. Other than as stated in the two preceding sentences, none of the Purchaser, Enterprises (U.S.), B.V., Enterprises or CPL or, to the best knowledge of the Purchaser, any of the persons listed in Schedules A, B, C or D hereto, or any associate or majority owned subsidiary of the Purchaser, Enterprises (U.S.), B.V., Enterprises or CPL or any of the persons so listed, owns or has a right to acquire directly or indirectly any equity security of the Company, and none of the Purchaser, Enterprises (U.S.), B.V., Enterprises or CPL or, to the best knowledge of the Purchaser, any of the other persons referred to above, or any of the respective executive officers, directors or subsidiaries of any of the foregoing, has effected any transaction in any equity security of the Company during the past 60 days.

The CHAIRMAN. Very good. Before going to questions, I would just like to express appreciation—and I have never had the occasion to do this before—to the staff of the Joint Tax Committee, who through the years has been one of the finest and most professional and competent staffs that I have dealt with in the Congress, and have been of immense help in many, many areas. I have found them all professional, totally nonpartisan.

And in this particular case I appreciate the assistance and help that you have provided to the staff of the Foreign Relations Committee in an area that is a pretty technical area, and we have appreciated that.

The treaty does contain provisions which would override certain provisions of the 1981 Foreign Investment in U.S. Real Property Tax Act. Can we expect a problem with this on the floor? Did the U.S. negotiators consult with the appropriate committees on this issue, to your knowledge?

Mr. GORDON. To our knowledge, there were no formal consultations with the tax-writing committees on this issue.

TREATY REPRESENTS IMPROVEMENT

The CHAIRMAN. On the question that I discussed with the Secretary of nondiscrimination, in your judgment does this treaty represent an improvement?

Mr. GORDON. Yes; it is a much broader provision than you find in the current treaty.

The CHAIRMAN. Taking into account that it does not conform to the model tax treaty and is inferior, from our standpoint, to the OECD treaty, could we have done better, in your judgment?

Mr. GORDON. We have had extensive discussions on this point with persons who were involved in the negotiation from prior administrations, and the negotiations go back at least two administrations, and they did not think so. They thought that this was the best that the Canadians would be willing to give and was the best that they have given to any other treaty partner.

The CHAIRMAN. The Treasury Department does not like to link economic issues. Linkage is a political fact of life, as the President, Secretary Haig, and others have said. But they, the Treasury, does not want to link other economic issues, such as the Canadian national energy program, with its tax treaties.

What are your views with respect to the linkage of other U.S. goals with the negotiation of a tax treaty?

Mr. GORDON. Well, you are getting a little bit outside our area of expertise. But looking at the treaties that are before you, both this one and the treaties that you are going to be considering this afternoon, there obviously are linkages to other economic issues. If you have treaties that are negotiated not purely for tax policy reasons, obviously there are other concerns that get involved in the treaty based on what kind of treaty we have.

I guess tax treaties were developed basically to solve very narrow, technical problems, and so the policy over the years has been not to link, just to deal with these limited cases of double taxation, basically between developed OECD countries. I guess as you extend your treaty network other factors become important.

The CHAIRMAN. Just on balance, in your judgment does this treaty represent a net gain to U.S. economic interests? I hope it would be a net gain to both countries; it would be a good balanced treaty. But looking at it again just from our standpoint, which is our job here, does it represent a net gain to U.S. economic interests and would you strongly recommend that the Senate give its advice and consent to the ratification of this treaty as it was negotiated because of that conclusion?

Mr. GORDON. The treaty that you have before you I would say is on balance, at least for a large number of people, a better treaty than we have today. It provides for a lot of improvements in administration, it provides lower withholding taxes. The lower dividend withholding tax is important to a lot of people.

I think as far as the number of individuals affected it is an important improvement. It deals with a number of issues that concern United States and Canadian residents who live on one side of the border and move over to the other side of the border.

There are taxpayers who are adversely affected, and the committee may want to consider soliciting additional written comments, as you already have, before making that final determination. It is very hard to say whether on balance it is better for the bulk of Americans than what you have today. Most of the comments we have heard generally are favorable, but there are some significant concerns.

The CHAIRMAN. I think we would like to have a written statement, if it can be prepared. It would be valuable to the members, particularly considering that so many were not able to be here today.

Finally, as tax experts, were you here for the entire testimony given by the Secretary?

Mr. GORDON. Yes, sir.

The CHAIRMAN. Is there any aspect of Mr. Chapoton's testimony on which you would like to comment? Do you as tax experts disagree with any of his statements that were made?

Mr. GORDON. There is nothing that comes to mind with which we would disagree. We would like to review the record. If anything does come out of the record, we would like to submit a written response. But as far as we are concerned, we do not disagree with anything he said up to this point.

The **Chairman**. Fine. Thank you very much.

Would any of your colleagues wish to make a comment?

Mr. **Brockway**. No, Mr. Chairman.

The **Chairman**. Gentlemen, thank you. We very much appreciate your being here.

Our final panel will consist of Mr. Sheldon Cohen on behalf of U.S. border broadcasters and Mr. Dennis J. Ellis, director of taxes, Viacom International, Inc.

We will recess for 3 minutes. I must take an urgent telephone call from the State Department involving our legislation that will be on the floor in a few minutes. I will be back just as quickly as I can.

[Brief recess.]

The **Chairman**. Let me say that solving a crisis that I thought could be solved in 3 minutes took a little bit longer. And I am not sure we solved it in that conversation.

I have just received, and did not have it at the opening of this hearing, a reply from Congressman Dan Rostenkowski, chairman of the Ways and Means Committee and also of the Joint Committee on Taxation. Senator Mathias and I had invited both Congressman Rostenkowski and Senator Dole to submit testimony on the tax treaty process. We have just received this letter and statement from Congressman Rostenkowski, and without objection I would want it inserted in the record at this point.

[Letter from Senators Percy and Mathias, as well as Congressman Rostenkowski's letter and prepared statement follow:]

September 15, 1981.

Hon. Dan Rostenkowski,
Chairman, Joint Committee on Taxation, U.S. House of Representatives, Washington, D.C.

Dear Congressman Rostenkowski: In your capacity as Chairman of both the House Committee on Ways and Means and of the Joint Committee on Taxation, we would like to invite you to appear during the September 24, 1981 hearings of the Foreign Relations Committee on a series of tax treaties. Senator Percy will be chairing the hearing on the Tax Treaty with Canada beginning at 10:00 a.m., and Senator Mathias will be chairing a hearing on ten other tax treaties beginning at 2:00 p.m. the same day.

In view of the impact of these treaties on our tax system, we would like to be sure that they have the general support of you and the membership of the tax-writing committees. We would be glad to accommodate an appearance by you or another member of the House from your committee either in the morning or the afternoon hearing. We are also extending a similar invitation to Bob Dole.

We will be hearing testimony from members of the staff of the Joint Committee on Taxation, who have already provided our Committee with an excellent series of analyses of the treaties presently before us for consideration. We appreciate their excellent contributions in this regard.

Sincerely,

Charles H. Percy,
Chairman.
Charles McC. Mathias, Jr.,
Chairman, Subcommittee on International Economic Policy.

Committee on Ways and Means,
U.S. House of Representatives,
Washington, D.C., September 24, 1981.

Hon. Charles H. Percy,
Chairman, Senate Committee on Foreign Relations,
U.S. Senate, Washington, D.C.

Dear Senator Percy: Thank you for your thoughtful letter inviting the Ways and Means Committee's view on the tax treaties presently pending before the Senate Committee on Foreign Relations. We are enclosing a statement for the Committee's September 24 hearing record which expresses our views on this matter; the Honorable Barber B. Conable, Jr., ranking minority member of the House Ways and Means Committee, joins me in this submission and a supplemental statement of Mr. Conable's is enclosed as well.

We very much appreciate the courtesy you have extended to us by inviting our comment on these treaties. As you have observed, these tax treaties do have a direct impact on our tax system; as such they deserve a careful review by the tax-writing Committees of Congress. While time has not permitted us to consult with the full membership of the Ways and Means Committee, the enclosed statement addresses those provisions of the pending treaties which cause the greatest concern, a concern that we believe will be generally shared by the Committee. In addition, we have taken this opportunity to express our deep frustration with the tax treaty process as it currently exists.

We view our efforts today as but a first step in developing a better understanding with the executive branch on tax treaty policies and in improving the process of negotiation and ratification of tax treaties which amend substantive tax laws and policies. It is our intention to pursue the issues that we have raised in further discussions with Ways and Means Committee members and the Treasury Department. We will make every effort to submit to you expeditiously any further recommendations we may have on these specific treaties since we understand that the Committee would like to schedule a final markup session on these treaties in mid-October.

Once again, thank you for your consideration of our views on this important matter.

Sincerely yours,

Dan Rostenkowski, *Chairman.*

Enclosures.

Prepared Statement of Hon. Dan Rostenkowski, a Representative in Congress from Illinois

Mr. Chairman, I very much appreciate your invitation to submit a statement to the Committee in order to set forth the views of the House Committee on Ways and Means regarding the tax treaties and protocols presently under consideration by the Committee. The Honorable Barber B. Conable, Jr., ranking minority member of the Committee on Ways and Means, concurs with the views expressed herein and is submitting a supplemental statement as well.

The tax treaties before you today raise a number of important tax policy issues and may prove to be precedent-setting, particularly in regard to future tax treaties with developing countries. As such, these tax treaties deserve very thorough consideration by this Committee as well as by the tax-writing Committees of both Houses. Indeed, since these treaties were largely negotiated by the last Administration, I would hope that the Treasury Department will also carefully evaluate these documents and their implications for U.S. treaty policy now and in the future.

Let me state at the outset that I am not satisfied with the process that has evolved for negotiating and ratifying tax treaties. As you are well aware, the Treasury Department has determined, with little or no input from the legislative branch, those countries with which to negotiate tax treaties and has proceeded to negotiate with those selected countries with virtually no oversight by Congress. The Senate is then presented with a "fait accompli" for ratification. To often the treaty presented conflicts with or negates the legislative tax policies that we in the tax writing Committees and in Congress have established. Such conflicts are present in some of the treaties before you today.

Also, I am not enthusiastic about the rationale which leads us to adopt a tax treaty with a country just for the sake of having a treaty. Why is it in the interest of the United States to have tax treaties with tax haven countries? Why do we want a concessionary tax treaty with a developing country where there is virtually no

U.S. investment to protect or one where there is little potential for double taxation? Today there are several treaties that fall into these categories.

It is unfortunate that a better understanding between the executive and legislative branches on an overall U.S. tax treaty policy has not been developed. The purpose of my testimony today is at least in part to lay the groundwork for a more consultative process in the future. I am hopeful that the bipartisan Congressional approach that we have undertaken today will encourage the Administration to work with us in that regard.

Let me assure you that I am most sensitive to your Constitutional role in this process. But I am also aware that it places a difficult burden on this Committee for us to come before you at this stage in the process and "Please don't report this tax treaty for ratification becuase it contravenes what we did in the Ways and Means Committee and in the Congress last year!" Yet that is the only recourse we, as a Committee have responsibility for our tax system, are left under the treaty process as it exists today.

Accordingly, it is our intention to pursue further discussions with the members of the Ways and Means Committee and the Treasury Department on these general problems we have with the treaty process and on the specific concerns set forth below with regard to some of these treaties. Clearly the effect in many cases has been to selectively amend legislatively adopted provisions in the Internal Revenue Code; as such the Ways and Means Committee has an unquestionable interest in these provisions. It is our hope that our views can be reconciled with regard to these treaties before you and that we can propose at an early date an improved process for dealing with tax treaties in the future.

With that introduction, let me turn first to the Canadian tax treaty as I realize it is viewed as the major treaty being considered today by this Committee. While the Canadian treaty raises a number of tax policy issues as are discussed in the materials prepared by the Joint Committee on Taxation staff, I will focus on only the most troublesome aspects from the Ways and Means Committee perspective.

Just last year Ways and Means reported and the Congress approved legislation to tax the capital gains of foreign investors in U.S. real property. The bill applies to dispositions after June 18, 1980, and all appreciation on dispositions coming under the bill is taxable. The bill also specifically recognized the need to coordinate these rules with potentially conflicting tax treaty provisions. Thus, the bill provided that treaty rules would prevail until January 1, 1985; at that time, the new Code rules would override any conflicting treaty provision. This decision was reiterated and refined in the Economy Recovery Tax Act of 1981 where we provided, as a technical amendment, that for treaties signed between January 1, 1981, and January 1, 1985, the treaty rules would apply for a maximum period of two years. I frankly do not know how Congress could make the point any clearer that we intend these Code rules to apply and that this tax is not negotiable.

Nevertheless, we are now presented with a treaty that excludes certain property from the tax—trade or business property—and allows Canadians a step-up in basis to the effective date of the new treaty for purposes of computing taxable gain on their property. Is this just the fitst step in a series to come of undoing the Foreign Investment in United States Real Property Tax Act? If we are to extend such concessions to Canada, I cannot imagine that our other major treaty partners will not demand the same treatment. I note that the Philippines treaty for example overturns the 1980 Act in total. Yet, I cannot fathom what principles of tax equity or of sound treaty policy would justify selective application of these new rules to only the citizens of certain countries. Should we then reconsider the wisdom of these new provisions in whole or in part? Must we override each treaty by new legislation? Or should we ask you to reserve ratification?

This one provision of the Canadian treaty is illustrative of the types of problems many of these treaty provisions pose for the tax writing Committees of Congress. I find this situation a most vexing one, and I confess to my own uncertainty about the appropriate solution, given that such a narrow range of options is available by the time a tax treaty reaches the ratification stage.

The proposed Canadian treaty poses a number of other issues that will concern members of the Ways and Means Committee. The treaty permits certain types of discrimination by Canada against U.S. investors. Yet many members have long objected to and are seeking an end to the Canadian treatment of business expenses for U.S. advertising and broadcasting which discriminates against U.S. taxpayers. We should be ending such discrimination, not endorsing it. In fact, retaliatory legislation may be introduced and considered this Congress in response to Canadian tax discrimination against U.S. television broadcasters.

Further, the treaty's provisions contradict the Code rules and IRS regulations in regard to the foreign tax credit. The Code provides an overall limit on the credit while the treaty applies percountry limitations. The treaty also implies that the rules concerning what taxes are creditable will be amended for Canada. While similar foreign tax credit problems are present in other existing and proposed treaties as well, the Ways and Means Committee is presented with a most difficult situation when the solutions we develop in Committee on such complex questions as these are then selectively amended by various tax treaties. Often this result clearly stems from an attempt to avoid the legislative process. One might well ask what the law actually if on foreign tax credit issues, that answer is, "It depends!"

Finally, the Canadian treaty permits U.S. residents to deduct charitable contributions made to Canadian charities and vice versa. A similar provision is also contained in the proposed treaty with Israel. By determining the U.S. tax treatment of U.S. taxpayers, this provision goes beyond the typical scope of tax treaties, may prove precedent-setting for future treaties and certainly contravenes the provisions in the I.R.C.

As I mentioned earlier, these are not the only troublesome provisions of this treaty, but they are those that cause the most difficulty for the House Ways and Means Committee because they directly conflict with legislative decisions. At the very least, Treasury must offer a persuasive defense of the policies proposed here, and it is our intention to pursue these issues further with the Administration. If it proves necessary, we will submit recommendations to this Committee as expeditiously as possible.

A number of the other proposed treaties contain provisions that represent questionable tax policy from our perspective. I will describe these briefly. As I mentioned above, the Philippines treaty also contravenes the 1980 Act on foreign investors in U.S. real estate. I do not believe the Ways and Means Committee will find a total negation of the 1980 Act acceptable, and we would therefore recommend reserving on this provision of the Philippines treaty. As the Joint Committee on Taxation will discuss, this treaty also contains a major issue of treaty policy in regard to reciprocal exemption of international aircraft operations.

The Israeli treaty, in addition to the concern I expressed earlier about allowing the deduction for charitable contributions to Israeli organizations, contains a troublesome provision on forced loans; the treaty allows compulsory loans to the Israeli government to be treated as income taxes eligible for the U.S. foreign tax credit. When the loans are repaid, they are to be treated as a refund of Israeli taxes and the taxpayer's creditable foreign taxes thereby reduced. As a matter of fact, this amounts to a loan to Israel from the U.S. government. Some may argue that this provision should not be of great concern because Israel no longer requires forced loans. However, the inclusion of such provisions can and does prove precedent-setting. The Morocco treaty has a similar provision on compulsory loans and Morocco still requires such loans of U.S. businesses.

The treaty with Jamaica also contains a provision that would be most controversial in the Ways and Means Committee. A protocol to the treaty extends the North American exception under the foreign convention rules, an exception adopted just last year for U.S. possessions, Canada and Mexico, to include Jamaica. As a result, conventions in Jamaica would be treated as held in the United States for tax purposes. Once again the traditional scope of tax treaties is expanded by determining the U.S. tax treatment of U.S. taxpayers. The Jamaican treaty does contain certain provisions of importance to the United States, such as broad anti-treaty shopping provisions and an agreement to negotiate mutual assistance provisions. Nevertheless, as a matter of tax policy, it is the tax-writing Committees and the Congress that should consider an expanded North American exception; further, if they did agree that an expansion was warranted, I am sure the members would logically consider including a broader group of other Caribbean countries. Once again we are troubled by this type of expansion of the scope of typical treaty provisions and it places the tax-writing Committees in a most awkward position.

Earlier, I touched on our difficulties with overriding the foreign tax credit rules by treaty in the context of the Canadian treaty. The proposed protocol with Norway presents an even more controversial issue; the protocol provides a U.S. foreign tax credit for a special tax Norway imposes on submarine petroleum resources. There is little doubt in my mind that this tax would not be considered a creditable income tax in the absence of this provision. As you will recall, a similar provision was included in the UK protocol ratified in 1979 and it too proved controversial. In light of that experience perhaps, the protocol with Norway contains a per country limitation on the credit.

As a tax policy matter, these provisions I have just described in the proposed treaties with Canada, the Philippines, Israel, Morocco, Jamaica and Norway cause me the greatest concern, a concern that I believe the members of the Ways and Means Committee will share. Further, it is somewhat alarming that the Treasury

Department is unable to provide us estimates of the expected revenue losses involved as this information is clearly needed to assist us in evaluating their significance. At this time we would recommend, as noted above, that the provision in the Philippines treaty which overrides the act on foreign investors in U.S. real property be reserved. The other issues I have raised will require additional discussions with Treasury.

Let me turn now to the basic questions posed by tax treaties with developing countries, as illustrated by several of the treaties before you today. Technically all these tax treaties except those with Canada and Norway are with developing countries. As such, we are forced to address the question of what our tax treaty policy should be with developing countries and when it is in the best interest of the United States to have such tas treaties in force. As a general rule, I can see no benefit to this country from a tax treaty with a developing country unless (1) there is significant U.S. investment taking place in the treaty country and, as a result, double taxation is occurring that should be resolved by treaty; or, (2) it is determined that the treaty country is being used to abuse or evade U.S. laws, and thus it is in our interest to have strong exchange of information provisions, anti-treaty shopping rules and mutual assistance agreements for law enforcement purposes.

We must recognize at the outset that developing countries have economic interests that differ dramatically from our own. Accordingly, they will want very different provisions in a treaty, provisions that will conflict with the treaty policy positions Treasury has taken in the U.S. model treaty. Developing countries will be most reluctant to forego source-based taxation and as a result, any treaties negotiated with developing countries will vary significantly from the rules we typically insist upon in regard to limitations on source-based taxation. This fact of life is illustrated in the provisions of the proposed treaties with Argentina, Bangladesh, BVI, Egypt, Israel, Jamaica, Malta and Morocco, all of which permit more source-based taxation than typical in U.S. tax treaties.

In addition, such countries will typically want other tax concessions, such as the treatment of forced loans in the Israeli and Moroccan treaties, and they will urge "tax sparing" provisions that represent a very significant departure from United States, and indeed international, tax policies. "Tax sparing" provisions in essence eliminate all tax, by both countries, on the profits and certain other types of income derived from investments in the treaty country. As an example of this potential problem, the Moroccan treaty is accompanied by an Exchange of Notes in which the United States agreed to resume discussions on incorporating a "tax sparing" credit at a later date.

We do not believe that the purpose of a tax treaty or of treaty provisions should be to eliminate all tax on certain activities producing income or profits, and we want to make that position clear to the Treasury Department as they consider future treaties with developing countries. This result is reached, though by a different route, in the proposed treaty with Argentina. Because Argentina has a strict territorial system, they do not tax any foreign source income of their residents. Accordingly, there is no possibility of double taxation from a U.S. tax on U.S. source income accruing to a resident of Argentina. The effect of the treaty then is to totally exempt such U.S. source income from tax. Many of our treaties provide that the United States will not forego tax unless the income is subject to tax by the treaty partner, and I do not understand why a similar provision has not been included here.

Frankly, given Argentina's territorial system one could question the need for this treaty at all. The treaty does not measure up under the general rule I have cited. It does not even measure up under the general rule I have cited. It does not even contain an anti-treaty shopping provision. Finally, its provisions on source-based taxation are among the most egregious of all in this class of treaties. Accordingly, we would recommend that Treasury be required to negotiate these two additional provisions—an anti-treaty shopping provision and one to insure that U.S. tax will not be foregone unless tax is paid to Argentina.

The proposed treaties with Bangladesh and Malta are the other two that I question the need for. There is little if any U.S. investment in these countries and the anti-treaty shopping provision in the treaty with Malta is not as strong as it should be. I hope Treasury will not pursue treaties of this type in the future.

For similar reasons, the proposed treaty with Cyprus was high on my list for severe criticism. In addition, Cyprus is an undisguised tax haven country. I am most relieved that the Administration has withdrawn this treaty and the BVI treaty. Congress cannot countenance tax treaties with haven countries. In fact, I was prepared to recommend that notice of our intent to terminate be given to the BVI, and I would urge this Committee and the Treasury Department to seriously consider this option between now and June 30, 1982, when such notice must be given. The treaty with the Netherlands Antilles should be studied in the same light. I am most skeptical about the wisdom of retaining the present treaties we have with haven countries, and I surely see no reason to invite new treaties with other haven countries.

Finally, I would hope this Committee would place a sunset date on any of these treaties with developing countries that you decide to report for ratification. These treaties are among the first we have negotiated with countries of this type and as such we are breaking new ground. Congress should assure itself that these treaties are of limited duration so that we may reassess them within a reasonable time period. Further, the Administration should consult with this Committee and the tax writing Committees before undertaking further negotiations with other developing countries. We must jointly agree upon some ground rules before proceeding further down this path.

Before closing, I would like to raise some administrative issues that are worthy of your consideration. Several of the proposed treaties contain broad and unprecedented delegations of authority to the competent authorities of the treaty countries, in essence to the IRS and the foreign tax administrators. The first permits the competent authorities to eliminate double taxation in cases not provided for in the treaty. Under a literal reading, this delegation could be interpreted to include double taxation arising from any source, even state unitary tax systems. Accordingly, the scope of this delegation of authority must be clarified and limited to include only noncontroversial technical matters, not items of substance. The competent authorities are also allowed to increase the dollar amounts specified in the treaties, but no standards are included to guide actions in this regard. Once again, the intended scope of this delegation must be established.

Finally, there has been an ongoing debate between the House Ways and Means Committee and the Treasury Department concerning Congressional oversight of the administration of treaty provisions by the U.S. competent authority. The standards treaty secrecy clause has been interpreted by the IRS to limit the access to such information to persons directly engaged in the assessment or collection of taxes. IRS, therefore, has not permitted the General Accounting Office, acting as an agent of the Ways and Means Committee, to review competent authority case files.

The Treasury Department has agreed, as a matter of principle, that such access for oversight purposes should be assured. To accomplish this result, Treasury agreed to add the term "administration" to the exchange of information clause as new treaties are negotiated and to clarify the intent of this change with our treaty partners. Further, Treasury agreed to use the mutual agreement process to gain the agreement of our present treaty partners. Still, I am informed by the Joint Committee on Taxation staff that this matter is not clearly resolved in the treaties before you. Therefore, I would urge that the Committee express its support of the need for Congressional oversight in this area and its understanding that our treaty partners will permit GAO access for this purpose when acting as our agent.

In all of these administrative matters I believe, and I hope Treasury will agree, that Senate guidance on the question will be adequate to resolve the matter to the satisfaction of all parties.

With that Mr. Chairman I will conclude, and I thank you again for your invitation and your indulgence. We intend to consult further on the matters I have raised today with members of the Ways and Means Committee and with the Administration. We will make every effort to submit to you in an expeditious fashion any further recommendations we may have on these specific treaties once those consultations are completed.

The CHAIRMAN. We are very pleased to have Sheldon Cohen appear before us on behalf of the U.S. border broadcasters, and Dennis J. Ellis, director of taxes for Viacom International, Inc. Would you identify your other colleague also.

Mr. ELLIS. To my left is Mr. John Berna, tax attorney for Viacom International.

The CHAIRMAN. Thank you.

Would you give the chair some idea of the length of your testimony? A complete copy of your testimony, of course, will be incorporated in the record.

Mr. ELLIS. My testimony will last approximately 5 minutes.

Mr. COHEN. No more than 5 minutes, sir.

The CHAIRMAN. Very good. Thank you very kindly.

Mr. Cohen, would you proceed.

[Mr. Cohen's biographical data follows:]

Biographical Data of Sheldon S. Cohen

Sheldon S. Cohen is the senior partner in the Washington, D.C., law firm of Cohen and Uretz. He received his A.B. with special honors from George Washington University in 1950 and his law degree with highest honors from George Washington University in 1952. Mr. Cohen served as the Commissioner of the Internal Revenue Service from 1965–1969, and as the Chief Counsel of the Internal Revenue Service from 1963–1965.

Mr. Cohen is the recipient of numerous honors, including the Alexander Hamilton Award, United States Department of the Treasury; he is active in numerous civic, educational, and charitable organizations, and is the author of numerous scholarly articles.

STATEMENT OF SHELDON S. COHEN, ESQ., ON BEHALF OF U.S. BORDER BROADCASTERS, WASHINGTON, D.C.

Mr. Cohen. I am Sheldon Cohen of the law firm of Cohen and Uretz in Washington, D.C., and I represent a group of border broadcasters which operate near the Canadian-United States border. They have been sorely injured, as you have noted this morning, sir, by the Canadian legislation, bill C–58, which was enacted in 1977 and at that time had about a $20 million damage on them.

We have been having numerous hearings on this issue before the Ways and Means and Finance Committees. This is our first opportunity to appear before you, sir, and I appreciate very much your allowing us to testify.

Pursuant to a 301 complaint under the Trade Act of 1974, President Carter found that the action by the Canadians in this legislative area was a violation of our statute, section 301, and recommended to the Congress that it pass legislation which would mirror the Canadian legislation. There were a variety of ideas considered and that was the least onerous on the Canadians, and it was decided as at least the first step to show the Canadians that the U.S. Government was sorely distressed by this legislation.

The Congress adjourned last year before that legislation could be considered. That legislative proposal and others are now being considered by both the Special Trade Representative and by the U.S. Treasury Department, and we understand that the President and the White House are involved in deciding what type of legislation should be proposed.

We would recommend strongly to this committee that no action toward ratification of this treaty be taken until the President has announced the action he believes appropriate to show the Canadians that indeed our Government and our Congress, the Senate particularly, believe that the ideas expressed in C–58 are not those ideas expressed between friendly parties.

It appalls me—and I have said this to my Canadian friends any number of times in discussing this issue—that friends that live this close can say certain ideas are not discussable in terms of resolving our differences. We will never resolve our differences if we do not sit down and discuss these issues.

And you, by your questions this morning and the answers received, have fully grasped the unfairness of C–58. It is entirely discriminatory against American broadcasters whose product is picked up for free by the Canadians, but who are not allowed to deduct anything by way of advertising because there is a 100-percent tariff. In effect, by disallowing the deduction to the Canadian businessmen who believe that American television might reach a vast audience in Canada, and indeed are correct, they are imposing in effect a 100-percent tariff on this idea stream which crosses the border.

I am pleased to know that the present Trade Representative, Mr. Brock, and his staff are greatly disturbed by this. The Treasury is considering a variety of ideas for legislation. We are not recommending strongly any one of those ideas. We just believe that the United States should take a very strong position and propose and enact the appropriate legislation.

The Chairman. Could you just suspend your comments for a moment. The other end of my aforementioned crisis is here in the next room.

[Recess.]

The Chairman. I am sorry for the interruption. Please continue, Mr. Cohen.

Mr. Cohen. I have one other comment, Senator Percy, which is that I believe a tax treaty is a part of an economic relationship between two countries. I am surprised by our Treasury's position that it would not take into account important aspects of the economic relationships of the two countries, because after all the tax system is a mirror of the economic system of a country.

Thank you, very much.

[Mr. Cohen's prepared statement follows:]

Prepared Statement of Sheldon S. Cohen

Mr. Chairman: Thank you for your kind invitation to appear before this Committee. I am appearing on behalf of a group of United States broadcasters who have stations along the northern United States near the Canadian-United States border. These broadcasters have been significantly injured by Canada's unreasonable denial of a tax deduction for advertising placed by Canadian businesses with U.S. broadcasters. Indeed, since enactment of Canadian Bill C-58 in 1977, our clients have suffered losses of approximately $20,000,000 per year.

In July, 1980, President Carter, responding to a Complaint filed by our clients with the United States Trade Representative, found this action by the Canadians to be a violation of Section 301 of the Trade Act of 1974 and recommended to the Congress legislation which would mirror the Canadian tax law. The President made this recommendation only after attempt to resolve this dispute by bilateral negotiation failed. Such legislation would have denied a deduction to United States advertisers buying advertising time on Canadian stations primarily to reach American audiences.

The 96th Congress adjourned without considering this proposal. We understand that the current administration is committed to redressing this unreasonable action of the Canadian Government by issuing a strong Presidential message and supporting retaliatory legislation unless Canada repeals its law. We hope that such a Presidential message to the Congress will be forthcoming very soon, but until such a message is conveyed, we oppose this Treaty's ratification as ill-timed. Therefore, we believe that this Committee should delay action on this Treaty until President Reagan has issued his message to the Congress.

I think a brief overview of the problem illustrates why ratification should be deferred.

In 1976, the Canadian Government enacted Bill C-58 which amended Section 19.1 of the Income Tax Act of Canada. The critical provision of this Bill provides; "In computing income, no deduction shall be made in respect of an otherwise deductible outlay or expense of a taxpayer made or incurred after this section comes into force, for an advertisement directed primarily to a market in Canada and broadcast by foreign broadcasting undertaking." The effect of this legislation has been to impose a 100 percent tariff on the export of U.S. advertising services to Canada.

The United States Government responded quickly to this problem, and as early as April and September of 1977, the U.S. Senate adopted resolutions calling on President Carter to "raise with the Government of Canada the question of impact of the recent provision of the Canadian tax code on the U.S. broadcasting industry with a view toward adjusting outstanding differences." (S. Res. 152). Various high-level government contacts between Canada and the United States included discussions of this issue. In fact, this matter was raised in the very context of the negotiations on this Treaty. Unfortunately, the matter was not resolved, with Canada insisting that the issue is largely an internal matter. Our government has consistently disagreed with that interpretation of C-58.

In August, 1978, the border broadcasters filed a Complaint under Section 301 of the Trade Act of 1974 with the United States Trade Representative. After hearings and a thorough review of the evidence, President Carter determined in July, 1980, that the Government of Canada acted unreasonably through passage of C-58, and that C-58 burdened and restrained U.S. commerce, all in violation of Section 301.

It is our understanding that the Reagan administration agrees with this finding and the President is committed to remedying this unreasonable restraint on trade. The administration is considering either mirror-image legislation similar to that proposed by President Carter or a broader statute which would empower the Secretary of the Treasury to institute sanctions whenever such discriminatory or unreasonable trade actions are taken by any foreign government, Canada or otherwise.

As I indicated at the outset, the border broadcasters' concern with this Treaty relates to timing and its broader implications on bilateral affairs between Canada and the United States. We similarly objected to the passage of H.R. 5973 which granted special tax treatment for the expenses incurred by U.S. citizens attending business conventions in Canada. This privilege was granted only after numerous leaders of the Congress expressed their hope that Canada would reciprocate and reform C-58. The Canadian Government has not reciprocated that Congressional expression of goodwill. The question I must respectfully raise is whether the combination of such legislation with the ratification of this tax treaty (which also provides special tax exemptions) may indicate to Canada that restrictive trade practices are not a critical concern of the United States Government?

Based upon discussions with members of this administration as well as with members of this Congress, we believe that nothing could be further from the truth. We believe and hope that this country is prepared to respond to the Canadians on this broadcasting dispute. Therefore, on behalf of the border broadcasters, we urge that the Senate defer its ratification of this Treaty, at least until a Presidential proposal detailing the remedy being sought has been received by the Congress. Such deferral would send the strongest message to the Canadian Government that this country requires fair and measured treatment of U.S. business concerns.

Thank you. I would be happy to answer any questions.

The CHAIRMAN. Thank you very much.

Mr. Ellis?

[Mr. Ellis' biographical data follows:]

BIOGRAPHICAL DATA OF DENNIS J. ELLIS

Mr. Ellis was born in New York City in 1945.

He graduated from Fordham University School of Business Administration with a Bachelor of Science Degree in Accounting in 1966, and from Fordham Law School with a Juris Doctor Degree in 1969.

Mr. Ellis became a member of the New York State Bar in 1969 and became a Certified Public Accountant in New York State in 1970.

Mr. Ellis joined Viacom International Inc. in 1975 and currently holds the position of Director of Taxes. Previous to his time at Viacom, he was employed by Arthur Young & Co. and F. W. Woolworth & Co. in similar capacities.

Mr. Ellis is a member of numerous professional organizations. He currently serves as Vice President of the International Tax Committee of Tax Executives Institute, New York Chapter.

He lives in Bronxville, New York, with his wife, Mary C. Ellis, and their three sons.

STATEMENT OF DENNIS J. ELLIS, DIRECTOR OF TAXES, VIACOM INTERNATIONAL, INC., ACCOMPANIED BY JOHN BERNA, TAX ATTORNEY, NEW YORK, N.Y.

Mr. Ellis. Thank you, Mr. Chairman. I wish to thank you and the committee for this opportunity to testify here this morning.

My name is Dennis J. Ellis and I am director of Taxes of Viacom International, Inc. Viacom is engaged in the businesses of worldwide television and feature film distribution, television program production, cable television, pay television programing, and radio and television broadcasting.

I would like to comment on article XII of the proposed United States-Canada income tax convention, which will allow both countries to impose a 10-percent withholding tax on royalties paid with respect to motion picture films and works on film or video tape for use in connection with television.

In contrast, article XIIIC of the current treaty imposes a 15-percent withholding tax on royalties paid for the use of motion picture films.

Contrary to popular belief, the current treaty does not impose a withholding tax on royalty remittances paid with respect to video tape programs. Viacom has received private rulings from both Revenue Canada and the Internal Revenue Service confirming this fact.

Early in 1979, the United States-Canadian treaty negotiations became involved in the dispute over Canada's disallowance of a deduction to Canadian businesses for advertising expenditures on U.S. border stations, and also in the reexamination of the U.S. foreign convention rules.

It has been reported that Treasury fought hard on the broadcast issue, but that Canada would not concede. Instead, Canada agreed to reduce the withholding rates on dividends and royalties from 15 percent to 10 percent and the U.S. negotiators agreed to exempt Canada from the foreign convention rules.

This concession by Canada, however, was not a concession at all as far as the television industry is concerned. Far from constituting a reduction of withholding tax rates from 15 percent to 10 percent, the proposed treaty imposes a new 10-percent withholding tax requirement that did not previously exist.

Although the issue of exemption from the U.S. foreign convention rules is now moot due to such exemption having been granted by code amendment in 1980, I question the fairness of labeling the reduction in the royalty withholding tax rate a concession when the coverage of the withholding tax provisions is greatly expanded.

This expanded coverage cannot be viewed as a mere updating due to technological change. The new provisions are specifically referenced to and solely impact the television industry. In contrast, the sole target of the royalty withholding tax provision of the current treaty was the motion picture industry. The current article XIIIC was added by the supplemental convention of June 12, 1950, at a time when television was in its economic infancy.

My purpose here today is to alert the committee to the very material expansion of the provisions in question, and the consequent burden it places on our operations in Canada and on the television industry as a whole.

I feel the United States made a significant concession to Canada with respect to the foreign convention rules and that the reciprocal concession made by Canada with respect to the rate of royalty withholding should have economic viability. I urge you to support the modification of the treaty that will now permit the taxation of video programs, or at the very least to seek a lower withholding rate for such video tape royalties. Thank you.

The CHAIRMAN. Mr. Ellis, I am sorry. Would you please suspend for a moment. I must take another telephone call.

[Brief recess.]

The CHAIRMAN. We will have just 5 minutes left. I apologize once again.

Mr. Ellis, you can take all of that time and I will submit questions to you for the record, or perhaps you could shorten your testimony and I will get a few questions in.

Mr. ELLIS. I just completed my last paragraph.

The CHAIRMAN. Thank you very much.

DEDUCTIBILITY OF EXPENSES INCURRED

First, Mr. Cohen, Congress already has granted North American status with respect to the deductibility of expenses incurred by Americans at conventions in Canada. This remedy happened well before the Senate began to consider the current tax treaty.

Would it not make more sense for us to follow the same course; namely, to seek assistance through domestic legislation, and forget about holding up the treaty, which is generally in U.S. interests?

Mr. COHEN. Well, I should comment that we gave up the convention issue because the Treasury aided that giving up. That is, it was part of the treaty process at the same time that they were proposing it in domestic legislation. So there was a two-pronged attack.

It was a great concession to the Canadian Government, about $100 million in trade, versus about $20 million here, at least $100 million.

We are not taking the position that the treaty ought not be ratified. There are other interests in the treaty and ours is very minor. But we do say that the Canadians ought to receive a message. The Congress, the Senate, in 1978 proposed a resolution, sent a resolution to the President, to urge him to press this issue. It has done this several times before.

I believe the Canadians have gotten the wrong message. They see our Treasury folding regularly and they say, the U.S. Government does not care. I think the way to say that we care is, until the legislation arrives here and at least the consideration begins, if you would hold up on ratification, that would send them a message that, yes, the Foreign Relations Committee does care.

WITHHOLDING TAXES

The CHAIRMAN. Mr. Ellis, why in your view was your industry made subject to the withholding tax?

Mr. ELLIS. I believe it was made subject by our negotiators not realizing that there was an expansion in this area. Up to a year and a half ago, I believe most companies in the industry were paying withholding tax on video tapes. I know that we were.

We were of the opinion, and had received advice to the effect, that video tapes were subject to withholding under the old treaty. Since that time, we have received a ruling from Revenue Canada to the exact opposite effect and have filed refund claims and have received refunds accordingly.

The CHAIRMAN. What will be your additional cost as a result of the new provision?

Mr. ELLIS. That is hard to estimate on an ongoing basis, because of the mix of the products that we distribute between film and video tape. At the present time we are better off under the old 15-percent withholding rate than we are under the proposed 10-percent rate. The dimensions are in the neighborhood currently of $500,000 a year.

The CHAIRMAN. Will you get any relief under U.S. tax laws?

Mr. ELLIS. Well, naturally, these withholding taxes are subject to foreign tax credit. That is the relief available. What one has to guard against is the possibility of too much foreign taxes, that would not be creditable in the future.

The CHAIRMAN. I would like to note for the record that Senator Pell has submitted several written questions to Treasury, and the record will be held open until we have answers back.

There being no further business, the committee is recessed until 2 p.m. this afternoon in this same room. Senator Mathias will chair that hearing.

[Whereupon, at 12 noon, the committee recessed, to reconvene at 2 p.m. the same day.]

AFTERNOON SESSION

The committee met, pursuant to recess, at 2:30 p.m., in room 4221, Dirksen Senate Office Building, Hon. Charles McC. Mathias, presiding.

Present: Senator Mathias.

Senator MATHIAS. The committee will come to order.

I want to apologize for having delayed you. But you have heard from the bells which ring in this room that activity on the floor is rather intense at this point. I might say further that from the temper of the debate in the Senate, activity will continue to be intense on the floor and that the Chair may from time to time have to go back for votes in order to complete this hearing today. Therefore, I will ask witnesses to continue, and we will have counsel preside during those interims when I have to go back and forth for a vote.

This morning the committee heard testimony on the income tax treaty with Canada. This afternoon the committee will consider 10 additional tax treaties, many of them with developing countries.

At the request of the Treasury Department we are withholding action for the time being—and I repeat, for the time being—on three additional treaties that have been pending in the committee. These three are with Denmark, with Cyprus, and with the British Virgin Islands.

Our first witness this afternoon is the Assistant Secretary for Tax Policy of the Department of the Treasury, Mr. John B. Chapoton, who is accompanied by Alan Granwell, International Tax Counsel of the Department.

Mr. Secretary.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY OF THE TREASURY, TAX POLICY, ACCOMPANIED BY ALAN W. GRANWELL, INTERNATIONAL TAX COUNSEL, DEPARTMENT OF THE TREASURY

Mr. CHAPOTON. Thank you, Mr. Chairman. I appreciate your holding this hearing and giving us an opportunity to testify. I also want to thank the committee for acceding to our request in postponing the hearings on the three treaties that you have mentioned.

Senator MATHIAS. As I have said, for the time being.

Mr. CHAPOTON. Oh, yes, for the time being.

We have a rather lengthy statement that was submitted for the record this morning, and I will attempt this afternoon to summarize the basic points. There are a few introductory comments that I would like to go through, and I will summarize some of the basic points on the 10 treaties that are before the committee this afternoon. I will attempt to do this as rapidly as possible, although we do have a lot to cover on these treaties and treaties in general.

Tax treaties are an important element in the international economic policy of the United States. One of the fundamental objectives of tax treaties is to minimize impediments to international flows of technology and capital.

Due in large part to the development by the OECD of a model income tax treaty, the general form and structure of income tax treaties has become largely standardized.

Income tax treaties reduce the prospect of international double taxation. In general, with respect to any particular item of income, the country in which the income arises is required by the treaty to reduce or eliminate its tax in favor of the tax in the country of residence of the recipient. In return, the residence country is obligated to relieve double taxation with respect to the tax which is imposed in the source country.

Treaties assure nondiscriminatory treatment under the tax law of one country for residents of the other or for corporations of the first country owned by residents of the other, and authorize consultation and exchange of information between the tax authorities of the two countries both as to matters of tax evasion and to prevent double taxation.

The United States includes in its tax treaties a "saving clause," under which the United States preserves its statutory right to tax its residents and its citizens wherever resident on their worldwide income.

U.S. tax treaties also include antiabuse provisions designed to prevent residents of third countries from channeling investments into the United States through the treaty country, thereby deriving treaty benefits to which they are not justifiably entitled.

If, for example, a resident of a third country establishes a corporation in the treaty country to make his investment in the United States, under appropriate circumstances the antiabuse provisions would permit the United States to impose its full statutory tax on payments to such a corporation.

This administration views a tax treaty as a contract between two countries designed to benefit directly the residents of those two countries and not indirectly residents of third countries.

The United States also now preserves in our new treaties the statutory right granted by Congress last year to tax gains of the resident of the treaty partner of the disposition of real property in the United States and of shares in a U.S. corporation which holds U.S. real property.

Eight of the treaties before you today, Mr. Chairman, are with developing countries. It long has been recognized that tax treaties between developing and developed countries pose a particular kind of problem not adequately dealt with by the OECD and U.S. model treaties. Let me summarize the essence of that problem.

In the typical relationship between the developed and the developing country, capital, technology, and services flow in substantial part to the developing country, and the income therefrom flows in large part back from the developing country to the developed country.

In a standard treaty it is the source country which makes the major revenue sacrifice. This places the developing country on the horns of a dilemma: It recognizes that it must reduce its frequently high source basis taxation in order to attract and hold foreign capital and technology, but it cannot afford the revenue sacrifice which would result from entering into a standard income tax treaty.

The typical solution sought by developing countries is to reduce sources basis taxation to some extent, though not to the extent of the standard models, and to ask the developed country to compensate the developing country for the revenue cost which is incurred by providing an incentive in the treaty for their residents to invest in the developing country.

Historically, the United States has not extended such incentives to developing countries. We have, however, responded in our treaty policy to the other concern of developing countries: Their need to conserve scarce revenues. We traditionally lower the thresholds for source basis taxation and the maximum rates of withholding permitted by the source country on investment income normally are higher than those provided in the U.S. model. They are, however, low enough to avoid excessive levels of source taxation.

In accordance with our usual procedure, Mr. Chairman, we are submitting for the record the Treasury's technical explanations of the 10 treaties that are being considered this afternoon.

We are resubmitting the explanation of the Philippine treaty, which was submitted for the first time in 1977 at the time of the committee's first consideration of that treaty. We have replaced one paragraph in that explanation of article 1 relating to the taxes covered, to correct an error.

The Norwegian treaty is being formally submitted to the committee for the first time. And in that connection, the explanation of article X of the Norway protocol, amending article 23 of the convention, relating to relief from double taxation, in the documents submitted today differs from the explanation as originally published. The Treasury Department will publish further explanation with respect to this article in the future, as we are doing for the Canadian treaty which was dicussed this morning.

Senator MATHIAS. Let me ask you, are the explanations you have just referred to already submitted, or are you submitting them at this time?

Mr. CHAPOTON. We are submitting them at this time.[1]

Senator MATHIAS. They will be included as part of the record.

Mr. CHAPOTON. Thank you, Mr. Chairman.

If I might, Mr. Chairman, let me note briefly the special provisions of the individual treaties that we think the committee will be particularly interested in hearing about. Then we will respond to any questions on those that you might want to inquire about further.

Regarding Norway, our present treaty entered into force in 1972. We are now proposing a protocol to incorporate into the treaty the special tax on submarine petroleum resources, which was first enacted by Norway in 1975. The special tax is imposed on income from oil and gas operations in the Norwegian fields of the North Sea, in addition to the ordinary corporate tax. The protocol also provides a special foreign tax credit limitation for taxpayers subject to the special tax.

The protocol establishes a single maximum withholding rate at source on dividends of 15 percent, eliminating the 10-percent rate formerly applicable to direct investment dividends. This change was made at the request of Norway in order to compensate, in part, for the revenue loss of its reduced corporate tax rate burden on distributed profits and to establish a uniform treatment of foreign investors in the Norwegian treaty network.

Regarding Jamaica, there is before the committee the basic Jamaica treaty and a protocol. Let me just mention the protocol, which I think is the more significant issue for the committee.

The central feature of the proposed protocol is the introduction of a new provision in article 25, relating to nondiscrimination, to provide that expenses for any business convention held in Jamaica, if they are ordinary and necessary business expenses under our law, will be deductible in the United States in the same way as if the convention were held in the United States.

The inclusion of the foreign convention provision in this protocol was motivated by the administration's desire to implement measures which would provide tangible economic benefits to Jamaica. There are also compensating benefits for the United States in that the protocol includes provisions to limit potential abuse of the treaty by denying treaty benefits in certain situations where we think those benefits were not intended.

Regarding Argentina, Argentina taxes all income derived from sources within Argentina by residents and nonresidents. It does not tax income arising outside Argentina. Therefore, the typical concern of developing countries—that reducing their tax at source in a treaty involves a revenue loss which may not be compensated by benefits they derive from the treaty—is exacerbated in the case of Argentina.

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[1] See app., p. 414.

Any rate reductions at source by the United States of income derived by residents of Argentina benefit those residents but do not compensate the Argentine Government for its reduced taxes, because, the United States income does not enter into the Argentina tax base.

Consequently, the treaty does not require any reduction in tax on royalties or on certain interest, such as interest on securities. However, Argentina agreed to exempt at source certain types of interest—most particularly, interest paid to the U.S. Government and certain interest insured by the U.S. Government.

In the case of dividends, Argentina wanted to reserve the right to increase its withholding tax—now it is 17.5 percent—to 20 percent, but agreed to do so only if it made a corresponding reduction in its corporate tax sufficient to maintain the combined burden at no higher than 45 percent, which is roughly the present level.

Let me turn to the Israeli treaty. There are three provisions, in particular, which I would like to note. First, the proposed treaty provides that Israel's compulsory loans are to be treated as creditable taxes in the year incurred. However, when the compulsory loan to the Israeli Government is repaid, the repayment is to be treated as a refund of foreign tax and the foreign tax credit is adjusted accordingly.

The compulsory loans would not be creditable under the Internal Revenue Code but they have the same economic effect, we feel, as taxes and therefore, we think this is a justifiable provision.

The second special provision states that a resident of one country may, subject to limitations, treat as charitable contributions for tax purposes in his country of reisdence certain contributions to qualifying charitable organizations in the other country, but the amount cannot exceed 25 percent of the taxpayer's income for the year from the country in which the donee charity is located. There is precedent for this provision both in the 1942 Canadian treaty and in the new Canadian treaty.

With respect to the third special provision under Article 13 of the new treaty with Israel, the general maximum rate of withholding at the source on interest is set at 17.5 percent. The effect of this relatively high rate of withholding is substantially mitigated by two important exceptions to the general rule. Interest derived by a financial institution may not be taxed at a rate in excess of 10 percent, and interest derived by or guaranteed by a government of either contracting state or instrumentality is exempted entirely from withholding.

Regarding Morocco, with respect to the Moroccan treaty, the following should be noted: The definition of royalties, which are taxable at source at a maximum rate of 10 percent, includes film rentals, payments for accessory technical services performed in the country in connection with the use of patents or similar rights in that country, and payments out of Moroccan Government funds for technical and economic studies performed for the Government.

The most unusual feature of the Moroccan treaty is the treatment of the amounts which corporations are required to invest in Moroccan Government bonds. Under the treaty, these amounts may be treated as income in the year invested, subject to any subsequent redemption being treated as a reduction in Moroccan taxes in the later year the redemption occurs.

As for the Philippines, the treaty with the Philippines was signed on October 1, 1976. It was considered by this committee in 1977, but no action was taken by the committee. The treaty does not contain the usual reciprocal exemption of shipping and airline profits. The Philippines is strongly opposed to such an exemption and has not agreed to it in any other treaty. They have agreed in the treaty to reduce their statutory tax on shipping profits from 2.5 percent to 1.5 percent of gross receipts on outbound traffic or any lower tax agreed to with a third country.

At the time the treaty was signed, U.S. airlines preferred not to include such a provision for airline profits, in order to avoid the precedent of a treaty provision other than reciprocal exemption. Subsequently, they have advised us that they would accept the same relief now afforded U.S. shipping companies.

We had hoped to complete a protocol to that effect prior to these hearings, but it is now clear that it will be necessary to meet with the Philippines officials to try to negotiate an acceptable solution.

We believe, despite this omission, that the treaty as signed is beneficial to U.S. investors and should enter into force.

As for Bangladesh, there is very little in this treaty between the United States and Bangladesh which requires special comment. The treaty differs from the U.S. model in allowing profits derived from international shipping to be taxed by the source country. The United States prefers a reciprocal tax exemption for profits derived from international shipping. In that regard, profits from such activities is becoming an increasingly important source of revenue for developing countries. In recent years many developing countries have refused to exempt profits derived from international shipping from tax under income tax treaties.

The provision in this treaty was agreed to in the context of a balanced agreement which provides benefits to other U.S. businesses. Since Bangladesh will not agree to a reduction in tax at source in treaty negotiations with other countries, no competitive disadvantage to U.S. shippers is created.

The proposed treaties with Malta and Egypt do not raise any issues requiring special comment. We would be happy to comment on those if you have any specific questions.

As far as the German Estate and Gift Treaty is concerned, the proposed treaty with Germany comports with the current treaty position of the United States to tax primarily on the basis of domicile rather than on the basis of situs. We think beyond that it requires no special comment.

Mr. Chairman, we would like to urge the committee to consider favorably these treaties and protocols. I would be happy to answer any questions that you may have.

[Mr. Chapoton's prepared statement follows:]

PREPARED STATEMENT OF HON. JOHN E. CHAPOTON

Mr. Chairman and Members of the Committee: I am pleased to have the opportunity to appear before your Committee this afternoon in support of ten tax treaties. I urge their prompt approval. I would also like to thank the Committee for agreeing to our request to postpone hearings on the proposed treaties with Denmark, Cyprus and the British Virgin Islands. I would like to introduce into the record at this time a copy of my letter to the Chairman requesting these postponements.

Tax treaties are an important element in the international economic policy of the United States, one of the fundamental objectives of which is to minimize impediments to international flows of capital and technology.

FUNCTION AND STRUCTURE OF INCOME TAX TREATIES

Due in large part to the development by the OECD of a Model Income Tax Treaty, the general form and structure of income tax treaties has become largely standardized.

Income tax treaties reduce the prospect of international double taxation. In general, with respect to any particular item of income, the country in which the income arises is required by the treaty to reduce or eliminate its tax in favor of the tax in the country of residence of the recipient. In return, the residence country is obligated to relieve double taxation with respect to the tax which is imposed in the source country.

Treaties assure non-discriminatory treatment under the tax laws of one country for residents of the other or for corporations of the first country owned by residents of the other, and authorize consultation and exchange of information between the tax authorities of the two countries both as to matters of tax evasion and to prevent double taxation.

U.S. INCOME TAX TREATY POLICY

The United States includes in its tax treaties a "saving clause," under which the United States preserves its statutory right to tax its residents and its citizens, wherever resident, on their worldwide income.

U.S. tax treaties also include anti-abuse provisions designed to prevent residents of third countries from channeling investments into the United States through the treaty country, thereby, deriving treaty benefits to which they are not justifiably entitled. If, for example, a resident of a third country establishes a corporation in the treaty country to make his investment in the United States, under appropriate circumstances, the anti-abuse provisions would permit the United States to impose its full statutory tax on payments to such a corporation. This Administration views a tax treaty as a contract between two countries designed to benefit directly the residents of those two countries, and not indirectly residents of third countries. Anti-abuse provisions, therefore, will be employed wherever necessary, and in the form appropriate to the circumstances, to assure that U.S. tax treaties extend U.S. tax benefits consistent with this policy.

The United States also now preserves in our new treaties the statutory right granted by Congress last year to tax gains of a resident of the treaty partner on the disposition of real property in the United States and of shares in a U.S. corporation which holds U.S. real property.

DEVELOPING COUNTRY TAX TREATIES

Eight of the treaties before you today are with developing countries. It has long been recognized that tax treaties between developed and developing countries pose a particular kind of problem, not adequately dealt with in the OECD and U.S. Models, let me summarize the essence of this problem: In the typical relationship between a developed and a developing country, capital, technology and services flow in substantial part to the developing country and the income therefrom flows in large part from the developing country to the developed country. In a standard treaty, it is the source country which makes the major revenue sacrifice. This places the developing country on the horns of a dilemma. It recognizes that it must reduce its frequently high source basis taxation in order to attract and hold foreign capital and technology, but it cannot afford the revenue sacrifice which would result from entering into a standard income tax treaty.

The solution typically sought by developing countries is to reduce source basis taxation to some extent, though not to the extent of the standard models, and to ask the developed country to compensate the developing country for the revenue cost which is incurred by providing an incentive in the treaty for their residents to invest in the developing country. Historically, the United States has not extended such incentives to developing countries. We have, however, responded in our treaty policy to the other concern of developing countries—their need to conserve scarce revenues. For example, we lower thresholds for source basis taxation of both business income and personal services income by reducing the time or activity tests necessary for the source country to tax. Similarly, the maximum rates of withholding tax permitted by the source country on investment income are higher than those provided for in the U.S. Model. They are, however, generally low enough to avoid excessive levels of source taxation.

TREATIES CONSIDERED TODAY

In accordance with our usual procedure, I would like to submit, at this time, for the record, the Treasury's technical explanations of the ten treaties. We are resubmitting the explanation of the Philippine treaty, which was submitted in 1977, at the time of the Committee's first consideration of that treaty. We have replaced one paragraph in the explanation of Article 1 (Taxes Covered) to correct an error. The Norwegian treaty is being formally submitted to the Committee for the first time, in that connection, the explanation of Article X of the Norway Protocol, amending Article 23 (Relief from Double Taxation) of the Convention, in the document submitted today, differs from the explanations as originally published. The Treasury Department will publish, in the near future, further explanation of the more detailed rules of this Article.

Let me turn now to a discussion of the highlights of the individual treaties before you.

Norway

Our income tax treaty with Norway entered into force in 1972. The principal purpose of the proposed Protocol is to incorporate into the treaty the special tax on submarine petroleum resources which was first enacted by Norway in 1975. The special tax is imposed on income from oil and gas operations in the Norwegian fields of the North Sea, in addition to the ordinary corporate tax. The Protocol also provides a special foreign tax credit limitation for taxpayers subject to the special tax.

The Protocol establishes a single maximum withholding rate at source on dividends of 15 percent, eliminating the 10 percent rate formerly applicable to direct investment dividends. This change was made at the request of Norway in order to compensate, in part, for the revenue loss of its reduced corporate tax rate burden on distributed profits and to establish a uniform treatment of foreign investors in its treaty network.

Jamaica

The central feature of the proposed Protocol to the pending treaty is the introduction of a new provision in Article 25 (Non-Discrimination) of the treaty to provide that expenses for any business convention held in Jamaica, if they are ordinary and necessary business expenses, will be deductible in the same way as if the convention were held in the United States.

The inclusion of the foreign convention provision in the Protocol was motivated by the Administration's desire to implement measures which would provide tangible economic benefits to Jamaica.

There are also compensating benefits for the United States, in that the Protocol includes provisions to limit potential abuse of the treaty by denying treaty benefits in certain situations where benefits are not intended.

Argentina

Argentina taxes all income derived from sources within Argentina by residents and nonresidents. It does not tax income arising outside Argentina. Therefore, the typical concern of developing countries—that reducing their tax at source in a treaty involves a revenue loss which may not be compensated by benefits they derive from the treaty—is magnified in the case of Argentina. Any rate reductions at source by the United States on income derived by residents of Argentina benefit those residents but do not compensate the Argentine government for its reduced taxes, because the U.S. income does not enter Argentina's tax base.

Consequently, the treaty does not require any reduction in tax on royalties or on certain interest, such as interest on securities. However, Argentina agreed to exempt at source certain interest: interest paid to the U.S. Government and certain interest insured by the U.S. Government.

In the case of dividends, Argentina wanted to reserve the right to increase its withholding tax (now 17.5 percent) to 20 percent, but agreed that it would do so only if it made a corresponding reduction in its corporate tax sufficient to maintain the combined burden at no higher than 45 percent, which is roughly the present level.

Israel

There are three provisions, in particular, in this treaty which I would like to note.

First, the proposed treaty provides that Israel's compulsory loans are to be treated as creditable taxes in the year incurred. However, when a loan is repaid the repayment is to be treated as a refund of foreign tax with appropriate adjustments to U.S. tax liability at that time.

Though the compulsory loans are not creditable taxes under the Code since they are subsequently repaid, they have the same economic effect as taxes at the time they are made. It, therefore, seems reasonable to treat them as taxes which are subsequently refunded. This provision has only limited applicability.

The second special provision states that a resident of one country may, subject to limitations, treat as charitable contributions for tax purposes in his country of residence, certain contributions to qualifying charitable organizations in the other country. The amount, however, cannot exceed 25 percent of the taxpayer's income for the year from sources in Israel.

There is a precedent for such a provision, similarly limited, in the 1942 treaty with Canada.

Under Article 13, the general maximum rate of withholding at the source on interest is set at 17.5 percent. The effect of this relatively high rate of withholding is substantially mitigated by two important exceptions to the general rule. Interest derived by a financial institution may not be taxed at a rate in excess of 10 percent, and interest derived by or guaranteed by a Contracting State or instrumentality will be exempt.

Morocco

With respect to the Moroccan treaty, the following should be noted: the definition of royalties which are taxable at source at a maximum rate of 10 percent includes film rentals, payments for accessory technical services performed in the other country in connection with the use of patents or similar rights in that country, and payments out of Moroccan Government funds for technical and economic studies performed for the Government.

The most unusual feature of the Moroccan treaty is the treatment of the amounts which corporations are required to invest in Moroccan government bonds. Under the treaty, such amounts may be treated as an income tax in the year invested, subject to any subsequent redemption being treated as a reduction in Moroccan tax in that later year.

The Philippines

The treaty with the Philippines was signed on October 1, 1976. The treaty was considered by this Committee in 1977, but no action was taken.

The treaty does not contain the usual reciprocal exemption of shipping and airline profits. The Philippines is strongly opposed to such an exemption and have not agreed to it in any other treaty. They agreed in Article 9, to reduce their statutory tax on shipping profits from 2½ to 1½ percent of gross receipts on outbound traffic or any lower tax agreed to with a third country.

At the time the treaty was signed U.S. airlines preferred not to include such a provision for airline profits in order to avoid the precedent of a treaty provision other than reciprocal exemption. Subsequently, they have advised us that they would accept the same relief now afforded U.S. shipping companies. We had hoped to complete a protocol to that effect prior to these hearings but it is now clear that it will be necessary to meet with Philippine's officials to try to negotiate an acceptable solution. We believe that, despite this omission, the treaty as signed is beneficial to U.S. investors and should enter into force.

Bangladesh

There is very little in the treaty between the United States and Bangladesh which requires special comment.

The Bangladesh treaty differs from the U.S. Model in allowing profits derived from international shipping to be taxed by the source country. The United States prefers a reciprocal tax exemption for profits derived from international shipping. However, profit from such activities is becoming an increasingly important source of revenue for developing countries. In recent years, many developing countries have refused to exempt profits derived from international shipping from tax under income tax treaties. The provisions was agreed to in the context of a balanced agreement which provides benefits to other U.S. businesses. Since Bangladesh will not agree to a reduction in tax at source in treaty negotiations with other countries, no competitive disadvantage to U.S. shippers is created.

The proposed treaties with Malta and Egypt do not raise issues requiring special comment.

Germany

The proposed estate and gift tax treaty with Germany comports with the current treaty position of the United States to tax primarily on the basis of domicile, rather than on the basis of situs. It does not require special comment.

In conclusion, I would urge, once again, that this Committee take prompt and favorable action on all ten of the treaties which we have discussed this afternoon.

TERMINATION OF BRITISH VIRGIN ISLANDS TREATY

Senator MATHIAS. Let me ask one preliminary question about a treaty that is not before us. In your letter of the 15th of this month you said you were going to serve notice of termination of the British Virgin Islands Treaty, the current treaty, in early 1982.

Now, if you are not successful in renegotiating some of the troublesome provisions that are in the treaty, what is your proposal?

Mr. CHAPOTON. Mr. Chairman, our thought is that we should serve notice to terminate the existing treaty effective January 1, 1982.

Senator MATHIAS. In other words, that will be an encouragement to negotiate?

Mr. CHAPOTON. It would be an encouragement. We feel that the proposed treaty, for the reasons that we have stated, needs to be renegotiated, that the existing treaty is not acceptable; and therefore, we feel it mandatory that it be renegotiated.

Senator MATHIAS. Can you assure us that you will keep the committee fully informed?

Mr. CHAPOTON. Yes; we will. We have talked to counsel for the committee about this very question, and we do want to comport with the usual procedures.

ISRAELI/MOROCCAN TREATIES

Senator MATHIAS. All right. In reference to the Israeli treaty and the Moroccan treaty, you referred to the mandatory loans or the compulsory loans which get treatment as if they were taxes until refunded.

Mr. CHAPOTON. Correct.

Senator MATHIAS. Have we ever had similar arrangements in treaties in the past?

Mr. CHAPOTON. Not to my knowledge, no, sir. I am advised that we have not.

Senator MATHIAS. So this is a case of first impression for the Senate?

Mr. CHAPOTON. Yes, sir, it is. The Israeli compulsory loan provisions are being phased out. So it is of temporary consequence only. We felt, though, that the economic significance of the loans to the companies involved is the same as taxes.

JAMAICAN TREATY

Senator MATHIAS. Let me turn now to the Jamaican treaty. There is a provision which permits U.S. businessmen to deduct costs relating to conventions held in Jamaica. So this extends the area of deductibility geographically.

Mr. CHAPOTON. Yes, sir.

Senator MATHIAS. Beyond the borders of the Unitd States, which now will include Canada and Mexico as well as Jamaica.

Mr. CHAPOTON. That is correct.

Senator MATHIAS. Why? Here we are trying to save money in this country right now. We are over here on the Senate floor scrounging around for $1 billion here and $1 billion there. And you are providing for more deductions.

Mr. CHAPOTON. I think, Mr. Chairman, there is probably little, if any, revenue significance to the treaty provision, because if the convention were not held in Jamaica, it would probably be held somewhere else.

But there is a significant policy question involved here. This provision in the Jamaican treaty was granted in an effort to grant a tangible benefit to Jamaica. It was an administration decision.

Senator MATHIAS. Is there any quid pro quo?

Mr. CHAPOTON. There is quid pro quo in certain tightening provisions we asked for and received in the treaty, particularly a tighter anti-abuse provision, yes, sir.

PHILIPPINE TREATY

Senator MATHIAS. Now, you noted that the Philippine treaty had been pending since 1976.

Mr. CHAPOTON. Yes, sir.

Senator MATHIAS. What are the problems that have delayed the conclusion of that?

Mr. CHAPOTON. As I understand it, the treaty would have come before the Senate and presumably would have been approved before now except for the problem with airlines—the failure of the treaty to grant reciprocal exemption to both airlines and shipping. The airlines preferred to be taken out of the treaty, and that had the effect of delaying the treaty. We now wish to proceed with it in its present form, which would leave airlines out and provide a 1.5 percent at source for shipping.

And we do want to attempt to negotiate a protocol covering airlines. We will attempt to cover the airlines the treaty on the same basis as shipping, though I have to concede that it will be difficult to have the airlines receive the same treatment as shipping. We do not like the shipping and airline provision in the Philippine's treaty.

Senator MATHIAS. Would a Senate reservation on this point be fatal to the treaty, in your judgment?

Mr. CHAPOTON. I think it probably would be fatal to the treaty, and it would certainly be fatal to the shipping interests, because they have a concessionary 1.5-percent tax under the provision which would have to be reserved.

Senator MATHIAS. What is the state of play at the moment as between ourselves and the Philippine Government?

Mr. CHAPOTON. I beg your pardon?

Senator MATHIAS. What is the state of play right now? What is the current status of the negotiations?

Mr. CHAPOTON. We sought to negotiate a protocol incorporating airlines, but the Philippine Government refused our draft and we were unable to conclude a protocol in time for this hearing.

Though further negotiations are not now scheduled, we hope to schedule them shortly.

TREATY WITH NORWAY

Senator **Mathias**. Now, turning to Norway, there has been some discussion of this treaty and how it affects the U.S. interest, economic interest. What is your personal judgment as to the kind of balance that the treaty provides and the protocol provides as far as U.S. interests are concerned?

Mr. **Chapoton**. On balance, I think the protocol is both understandable and sound. It clarifies the creditability of the Norwegian special oil tax. It does permit taxation of the drilling contractors in cases where they have established, or will be deemed to have established, a permanent establishment in Norway. It should be noted that the threshold for taxation is lower than would normally have been the case absent the protocol.

However, Norway wanted to tax that activity, and would have insisted on it under the present treaty.

Senator **Mathias**. Now, one of the unusual features of the Norwegian tax structure is the submarine petroleum resource tax. And the Norway protocol makes creditable for tax purposes this tax on companies—which really means American companies—who are engaged in offshore production

Mr. **Chapoton**. Correct.

Senator **Mathias**. Would this tax be creditable if we did not approve the protocol?

Mr. **Chapoton**. It is not clear whether that tax would be creditable under the code.

Senator **Mathias**. But it is clear if we do approve it?

Mr. **Chapoton**. It is clear if we do approve it.

Senator **Mathias**. All right.

Mr. **Chapoton**. It is creditable subject to a per-country limitation; that is, that tax cannot be used to offset other——

Senator **Mathias**. If it is not clear, why did you include it?

Mr. **Chapoton**. Well, one of the principal purposes of the protocol is to resolve that question and not leave it open.

Senator **Mathias**. Will the administration issue any regulations which further define this question?

Mr. **Chapoton**. We are working on, and the previous administration had issued, a set of regulations dealing with the entire foreign tax credit area. We are in the middle of reexamining that question right now and will be issuing revised foreign tax credit regulations.

ARGENTINE TREATY

Senator **Mathias**. Now, turning to Argentina, you noted that Argentina does not tax any external source income.

Mr. **Chapoton**. Correct.

Senator **Mathias**. Should we consider forgoing the elimination of the U.S. tax on those sources of income which would otherwise go without any taxation whatever; in other words, those that could fall down the crack between the two tax systems?

Mr. **Chapoton**. Well, we, of course, in the treaty do reduce the tax on the U.S. income of an Argentine resident. There is no benefit to the Argentine Government from that change, but we think that does attract investment to the United States and is the type of provision we normally put in treaties.

We think it is appropriate here. There is substantial U.S. investment in Argentina, and we think that the benefits, though not great, because, as I explained, of Argentina's reluctance to reduce its source basis taxation, are significant. And certainly is provided, as is always the case with a tax treaty.

Senator MATHIAS. Of course, instead of tax paying, it is tax sparing.

Mr. CHAPOTON. Well, to the extent the treaty provides for it, there is a reduction in tax on U.S. source income.

Senator MATHIAS. Now, assuming we agree with you on the general policy implications of this, what protection do we have against third parties that might be tending to abuse the privilege?

Mr. CHAPOTON. There is no antiabuse provision in the Argentine treaty, but the Argentine domestic taxes are high enough, we think, to make it quite unlikely that it would be used for treaty-shopping purposes, though we would, if we were renegotiating that treaty today, insist that such a provision be in the treaty.

Senator MATHIAS. Well, several congressional committees will have an interest in how these treaties work out in practice. International agreements sometimes have effects which are not foreseen when they are entered into.

Are you convinced that there is adequate congressional oversight available as these treaties go into effect?

Mr. CHAPOTON. There is a question which has arisen in connection with the secrecy requirement in treaties as to whether they permit the GAO to be given information on the effects of treaties. We support giving that information. In future treaties we will make it specific that there is that authority. Where we do not have explicit authority, we will seek to obtain it from the treaty partner.

Senator MATHIAS. Thank you very much, Mr. Secretary. We appreciate your testimony and the answer to your questions. I would just note that on two of the deferred treaties, Cyprus and the British Virgin Islands, we are aware that they are frequently called tax havens, and we will be following your negotiation on those very closely.

Mr. CHAPOTON. Yes, Mr. Chairman. May I ask that my letter to those two treaties be made a part of the record? I think it would be helpful.

Senator MATHIAS. It will be made a part of the record.

Mr. CHAPOTON. Thank you, Mr. Chairman.

[The letter referred to follows:]

DEPARTMENT OF THE TREASURY,
Washington, D.C., September 15, 1981.

Hon. CHARLES H. PERCY,
Chairman, Senate Committee on Foreign Relations,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: I am writing with reference to the hearings scheduled by the Foreign Relations Committee on September 24, 1981, to consider fourteen pending tax treaties. For reasons which I will explain, I am hereby requesting that the Committee's consideration of the treaties with Denmark, Cyprus and the British Virgin Islands be delayed to give the Treasury Department time to negotiate certain modifications in those treaties.

Because of a recent amendment to Denmark's tax law, modifying the manner in which Danish corporations and their shareholders are taxed, Danish tax officials have requested that we renegotiate one provision of the pending treaty before it enters into force. We would like to accommodate Denmark's request. We intend to negotiate a Protocol to the Danish treaty. That Protocol, when signed, will be transmitted to the Senate for consideration along with the treaty which is now pending.

With respect to Cyprus and the British Virgin Islands, our desire to amend the treaties has come about as a result of our review of these treaties in preparation for hearings. Both of these jurisdictions are tax havens. The pending treaties with both were designed to prevent, or at least limit the extent to which residents of third countries can use these treaties, in conjunction with favorable internal law provisions in those jurisdictions, to receive U.S. treaty benefits. We have concluded, on the basis of our review of these treaties that the opportunities which potentially remain for such use are too great for us to tolerate. We intend to raise our concerns with the Governments of both jurisdictions, and seek modifications in these treaties consistent with our present policy.

Although we are confident that the proposed British Virgin Islands treaty can be satisfactorily renegotiated, the existing British Virgin Islands treaty has been, and will continue to be as long as it is in force, subject to greater abuse than is likely to occur under the proposed treaty. Thus, in light of our concerns as expressed above, if satisfactory negotiations are not concluded by early 1982, the Administration intends to serve notice of termination of the existing treaty in accordance with its terms. In such event, termination would be effective January 1, 1983.

It should be noted that this procedure is not necessary with respect to Cyprus, since there is no existing treaty in force.

I hope that you will agree to delay consideration of these three treaties.

With best wishes.

Sincerely,

JOHN E. CHAPOTON,
Assistant Secretary (Tax Policy).

Senator MATHIAS. Our next witnesses are Mr. David H. Brockway, Deputy Chief of Staff of the Joint Committee on Taxation; and Mr. Richard A. Gordon, International Tax Council of the Joint Committee.

[Pause.]

Mr. TIPSON. For the benefit of the audience, let me say that my name is Fred Tipson. I am the chief counsel for the Senate Foreign Relations Committee, and I find it supremely ironic that having lurked in the shadows for years, and finally having my chance to ask questions at a Foreign Relations Committee hearing, it comes on a subject about which I have not the faintest clue. [General laughter.]

I will do my very best, and with the aid of the able minority staff, we will attempt to keep the hearing going until Senator Mathias returns.

May we clarify that point about the Argentine treaty, Dick, before you get into your statement. Do you agree with that interpretation of the Argentine treaty as far as third-party use of Argentina?

STATEMENT OF RICHARD A. GORDON, INTERNATIONAL TAX COUNSEL, JOINT COMMITTEE ON TAXATION, ACCOMPANIED BY DAVID H. BROCKWAY, DEPUTY CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION, AND THOMAS JOYCE, ACCOUNTANT, JOINT COMMITTEE ON TAXATION

Mr. GORDON. Our concern with the Argentine treaty is not that there definitely can be third-party use, but that Argentina has a unique tax system. They do not tax any foreign source income. So the issue is not so much whether Argentina would tax income at a high rate of tax but whether, under the meshing of the U.S. internal rules and the treaty rules and Argentina's territorial system, somebody who uses an Argentine company to do business in the United States could avoid all tax.

There is a provision in the treaty dealing with foreign investment in U.S. real property, and there is apparently a fair amount of Argentine investment in U.S. real estate. That provision does not really mesh with our code rules. It is somewhat more liberal. And I would imagine that there are certain cases in which Argentine residents can avoid paying tax on their U.S. real property investments that they should be paying under the code.

So I guess, as Mr. Chapoton indicated, we certainly would prefer to see an antiabuse provision in that treaty.

Mr. TIPSON. If the Treasury Department has any further comments on that point, I wish you would submit them for the record.

[The following information was subsequently supplied for the record:]

ANTIABUSE PROVISION IN THE PROPOSED TREATY WITH ARGENTINA

[SUPPLIED BY THE DEPARTMENT OF THE TREASURY]

We do not believe the treaty with Argentina would be used to avoid tax. A third country resident could secure a reduction in the United States withholding tax on dividends from 30 to 20 percent, but to get the dividends out of Argentina would have to pay a 17.5 percent tax to Argentina. There would be no reduction under the treaty in United States withholding on interest or royalties. The potential for abuse in the business profits area is limited to those activities, if any, which would constitute a trade or business under the Internal Revenue Code and generate significant taxable income, but would not be a permanent establishment under the treaty. The same opportunity exists in other treaties with countries which exempt foreign profits, e.g., France. Moreover, this treaty has a low threshold for having a permanent establishment, so the gap between statutory and treaty rules is narrower than in many other cases. The treaty would authorize the United States to tax gains on sales of United States real property or interests in United States real property held through a corporation, partnership, estate or trust whose property consists principally of United States real property. Although there are some differences between the provisions of the Code and the treaty with respect to sales of U.S. real property interests held through a corporation or other entity, they are relatively minor. In addition, as mentioned above, if a third country resident attempted to establish an Argentine company to take advantage of these differences, an Argentine tax would be imposed on distribution of profits.

Mr. TIPSON. I suppose we should identify the three gentlemen at the witness table right now. They are David H. Brockway, Deputy Chief of Staff of the Joint Committee on Taxation; Richard A. Gordon, International Tax Counsel, Joint Committee on Taxation; and Thomas Joyce, an accountant on the staff of the committee.

Please proceed, Richard.

Mr. GORDON. Thank you. It is a pleasure for us to appear here before you this afternoon to provide staff assistance to the committee in your consideration of these 10 agreements.

As in the past, we have prepared a series of pamphlets describing each of the various treaties before you. Each pamphlet has a summary which indicates the most important points in the treaties. They indicate how they may differ from normal U.S. treaties and from the OECD and U.S. model treaties. They also highlight some of what we consider to be the more significant issues presented by the treaties.

We also have prepared a written statement which we would like to submit for the record.

In preparing for these hearings, we had conversations with a number of tax experts, a number of academics who are expert in the international tax area, and with taxpayers who are affected by these treaties.

What I would like to do now, if I may, is to discuss just a few of what we consider to be the more important issues raised by this series of treaties and, in part, point out to the committee that they may want to make recommendations in their report or even possibly recommend understandings or reservations on a few of the provisions in the treaties.

We intend, in cooperation with the Foreign Relations Committee staff, to prepare some points for decision prior to consideration of these treaties in executive session.

I guess the one significant strain that ties a number of these treaties together is that they are with developing countries, and the United States has very few existing treaties with developing countries. The treaties, the few that we do have, generally have followed the OECD model and have been with countries with which we have had a special relationship, and who have not demanded significant concessions.

Also running through these treaties, are some significant tax policy issues and some technical problems which we feel should be addressed. We have discussed these at some length in our prepared statement and have made some specific recommendations in some cases. If we were to discuss them all here, we would be here into the evening.

So I think what I would like to do now is just basically list the areas that we feel do present some problems. If you have any questions, we will respond to them and, obviously, submit anything you may want for the record. We are available to discuss these problems with staff or committee members.

One area of concern is the relationship of these treaties to the foreign investment in U.S. real estate legislation which was adopted at the end of last year. This legislation was intended to tax foreign investors in U.S. real property when they disposed of that real property. A number of these treaties make changes in the technical rules of that legislation.

A couple of the treaties before you—Jamaica and Canada, which we discussed this morning—contain a provision which gives a deduction for U.S. business people attending foreign conventions. This opens up the whole issue of the extent to which treaties should be used to grant U.S. people deductions which are not otherwise granted by the Internal Revenue Code.

Another issue area in this regard is the granting of a charitable contribution deduction, in the Israeli and, once again, the Canadian treaty. I would like to point out there has been a provision like that in the Canadian treaty since 1942. But the Israeli treaty is an extension of that concept.

Another issue which was discussed during Mr. Chapoton's testimony is the issue of congressional oversight. This is certainly an issue of concern to the taxwriting committees. Basically, the Internal Revenue Service has taken the position that under most of the old treaties GAO cannot have access to mutual-agreement case files.

All of the treaties before the committee other than the Canadian and possibly the Argentinian treaty—I do not recall—have a word in there which Treasury assures us will give the congressional committees access. But the other eight treaties do present the problem.

It might be appropriate for the committee to consider reporting these treaties with an understanding that the oversight committees will have access as provided for under the Internal Revenue Code.

A number of these treaties also present an issue as to the extent to which the United States should demand nondiscriminatory treatment in tax treaties. This is a particular problem with developing countries, because they want to preserve scarce resources by encouraging those of their citizens and residents who have resources to invest them locally. There are some provisions in the Philippine treaty that would permit discriminatory treatment.

Generally, the United States has demanded an OECD-model type nondiscrimination article that prohibits almost all discrimination. It may be appropriate for the committee to consider whether this policy needs to be followed in developing countries treaties, and, if not, to what extent departures should be allowed.

Another area of concern in these treaties is the foreign tax credit. This comes up in the Norwegian treaty, which we will mention in a minute; also, in the Israeli and Moroccan treaties, which have a forced loan provision.

Under these provisions, the company investing in the country is required to make a loan to the country, and they get a foreign tax credit for that. At some point, the country repays the loan. At that point, the company will have to repay the tax to the U.S. Government. I think what you have really got is a loan running from the U.S. Government to the treasury of the other country. And I think that the committee certainly might want to consider whether this is an appropriate use of the tax treaty process.

Another issue which is presented in these treaties is the issue of third-country use. The Argentine and Philippine treaties do not contain any anti-treaty-shopping provisions. The committee might want to consider whether it is appropriate to enter a treaty with any country that does not contain some kind of antiabuse provision. At one point, even Canada was something of a tax haven, and I guess it can happen anyplace.

Just briefly, I would like to highlight the individual treaties and just state the issue or two in the individual treaties which we think the committee might want to focus on.

In the Argentine treaty, you have the issue of the anti-treaty-shopping rule and the extent to which we want to make developing-country concessions. The Argentine treaty does contain very few limits on source basis taxation, and some people have indicated to us their concern that it could be a model for South American tax treaties. It may be very appropriate, but it is something the committee may want to focus on.

In Bangladesh there is the issue of whether we should enter into a treaty without any limitation on source basis taxation of shipping income. Once again, a lot of developing countries probably consider this to be almost a non-negotiable issue.

In Egypt there really are no particular issues. Egypt does have a very minor form of discrimination against U.S. individual investors, but since there are, as we understand it, very few U.S. individual investors in Egypt, it does not seem to be terribly important.

Israel has the forced-loan provision. The Israeli treaty also has appended to it an exchange of notes in which Israel indicated that it cannot enter into routine exchanges of information because it does not have the facilities, the equipment, and the resources to supply the information at this time. I think the Israelis are probably being very forthcoming in saying this publicly.

Nevertheless, one of the two principal purposes for entering into a treaty is exchange of information. The committee may want to consider expressing its concern and suggesting that the Treasury Department carefully monitor the situation to be certain that the information is obtained when the Israelis are capable of giving it.

The other area of interest in the Israeli treaty is the charitable contribution provision.

With regard to the Jamaican treaty, you do have the business convention deduction issue, which is tied in the protocol to the antiabuse provision. Also very important, from the point of view of the law enforcement community, is a commitment on the part of Jamaica to enter into discussions of a modern mutual assistance and extradition treaty.

We are not aware of any particular issues or provisions in Malta that should cause the committee any concern.

Morocco has the forced-loan provision.

The Norwegian protocol contains the issue which has been described before of the foreign tax credits. It does make the Norwegian offshore petroleum tax creditable but subject to a per-country limitation.

In the Philippines, there is the airline issue, and the question is how the committee is going to dispose of that issue. The Philippines also has no antiabuse provision. It does permit some discrimination. The committee at this point might consider recommending ratification with recommendation to the Treasury that they negotiate some relief for the airlines. The Philippines has given some relief in their treaty with the Japanese. Treasury would have a better feel as to whether they can expect similar treatment.

Another concern in the Philippine treaty is that it contains a fairly broad override of certain provisions of our real estate legislation. This treaty was negotiated many years ago. I would say that we would recommend the committee consider a reservation on that point or at least an understanding that the treaty does not override the real property legislation. I do not believe, considering how old the treaty is, that the Philippine Government would object.

We are not aware of any particular provision contained in the German estate tax treaty that would warrant the committee's attention.

Thank you.

[Mr. Gordon's prepared statement follows:]

PREPARED STATEMENT OF RICHARD A. GORDON *

It is our pleasure to appear before you to provide staff assistance on the tax treaties and protocols which are currently under consideration by your Committee. As in the past, our staff has prepared separate pamphlets on each of the treaties and protocols before you; these pamphlets give an article by article description of each treaty or protocol and generally indicate those provisions which differ significantly from those normally found in U.S. treaties. The summaries of each of these pamphlets highlight the provisions of the proposed treaties which present significant policy issues. In addition, we have prepared a memorandum summarizing some of the general and specific issues raised by the various tax treaties before the Committee.

In preparing for this hearing, we analyzed the treaties, and also spoke with a number of attorneys, accountants, and business people who are familiar with the treaties. In this process, we worked closely with staff of the Senate Foreign Relations Committee and with Treasury.

The proposed treaties and protocols are, for the most part, noncontroversial. There are, however, a few controversial provisions in some of the treaties. In addition, the large number of treaties and the extension of the treaty network to less-developed countries which these treaties would represent present several important issues. Also, as treaties have become more specific, technical problems have developed which require greater attention.

In light of the materials which have already been provided to you, we will not describe the features of each treaty in this presentation. Instead, we would like to focus our discussion today on the relatively important tax policy issues presented by various provisions in these treaties. We will first discuss a number of issues which are raised in more than one treaty and then focus on some of the more controversial issues in the individual treaties.

In a few cases the committee may want to consider the option of a reservation or an understanding on a particular provision of the treaty. However, it is more likely that in most cases the provisions are not sufficiently troublesome or controversial that a recommendation of reservation or understanding with respect to any particular treaty provision need be seriously considered. Instead, in a number of instances the committee may want to consider stating in its report accompanying the resolution approving ratification that a particular provision is intended to be interpreted in a certain way or that the policy reflected in a particular provision not be viewed as precedent for future U.S. tax treaty negotiations. Indeed, in some of these areas the committee may want to recommend that, subsequent to ratification of these treaties, the policies embodied in certain provisions be reexamined by the Treasury Department, both in the context of legislative changes and in the context of the U.S. treaty negotiating position.

I. BACKGROUND

Most of the generic and specific issues cannot be addressed without considering the overall desirability of income tax treaties. A country clearly has the right to tax income earned within its borders at the rate it chooses. The wisdom of the rates and method of computing the tax base may be debated, the right to tax cannot be.

Most countries to tax local income whether paid to residents or to foreigners. When a country enters into a treaty, it agrees to limit its taxation of some local income. For example, if a U.S. resident works in a foreign country for one day, that country can tax that day's wages. By treaty, however, the country will generally agree not to tax those wages unless the U.S. resident works there for some significant period of time. The United States, of course, reciprocally agrees not to tax residents of the foreign country temporarily working in the United States. Likewise, a country can tax the gross dividends, interest, and royalties paid to foreign investors at whatever rate it chooses. (For example, the Internal Revenue code imposes a flat rate 30-percent tax on the gross amount of U.S. source passive income paid to foreign investors. Most other countries have comparable taxes.) By treaty, however, the United States and the foreign country will usually agree to make reciprocal reductions of this tax on income paid to investors in the other country.

By treaty, therefore, countries agree to limit both their jurisdiction to tax and their levels of tax. A U.S. resident's foreign tax burden is therefore generally

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* The proposed tax treaties other than that with Canada are discussed in a separate statement.

reduced by a treaty. Accordingly, most taxpayers will argue that any treaty that resembles the U.S. model treaty [1] is better than no treaty.

A treaty with one country is, however, often preceived as precedent by other treaty partners. Accordingly, a treaty with one country that provides for a relatively high rate of tax on passive income may save U.S. investors some tax as compared to no treaty at all with the country, but it may also encourage other countries not to lower their rates as much as they otherwise would. Also, if a treaty can be used by persons who are resident in third countries, it can lead to an erosion of the U.S. tax base without any reciprocal benefits. For example, if residents of nontreaty countries (in which United States persons invest) can invest in the United States through a treaty country, nontreaty countries have less incentive to enter into a treaty with the United States. Also, those that do negotiate treaties with us are under less pressure from their businesses investing in the United States to agree to reciprocal reductions in source basis taxation. Accordingly, in either case United States investors in foreign countries pay higher taxes than they otherwise might.

Treaties also provide U.S. persons investing in foreign countries with some certainty as to how their income will be taxed by that country. Establishing a treaty relationship can be a significant factor in making the climate for investment in that country more attractive to U.S. businesses.

A significant advantage to the United States as well as the treaty partner is that treaties provide for the exchange of tax information by the two countries and for a competent authority mechanism to resolve double taxation problems by mutual assistance. The IRS receives tax information from its treaty partners which help it in auditing multinational corporations and their dealings with their affiliates. Joint audit procedures, such as those with Canada, Germany, and the United Kingdom, are also possible if a treaty relationship is established.

We would like to address some issues raised by the particular treaties before you.

II. GENERAL ISSUES

A. Developing countries

Most existing United States tax treaties are with industrialized countries who are also members of the OECD. With a few notable exceptions these treaties follow a consistent pattern that generally gives the country of residence of the taxpayer the primary right to tax income with two exceptions: business income that is attributable to a permanent establishment in the other country; and income from real property.

The treaties and protocols before you this afternoon, other than the Norwegian Protocol and the German Estate tax treaty, are with developing countries.

For a variety of reasons, including the potential revenue loss and the difficulties in administering an extra territorial tax system, developing countries generally are opposed to yielding jurisdiction to tax income at its source. This philosophy is reflected in the United Nations Model for tax treaties between developed and developing countries, which includes fewer limitations on source basis taxation, than is the case in most United States income tax treaties, the United States Model, and the OECD Model.

Let us give you two examples of the lower limitations. First, treaties generally provide that a country can tax business profits only if they are attributable to a permanent establishment. A permanent establishment is defined in the most recent United States Model to include a building site or construction or installation project or the like but only if it lasts more than 12 months. Under this definition a construction project that lasts less than 12 months would not be a permanent establishment and the country of source would not be able to tax any of the profits generated. The U.N. Model, however, provides that the construction site will be a permanent establishment if it exists for 183 days or approximately 6 months. Accordingly, a permanent establishment will arise sooner under the U.N. Model, and the developing country will be able to tax those profits sooner. All of the treaties before you contain the 6-month rule. The model treaties contain a listing of activities that will generate a permanent establishment. Developing countries like to include in this list supervisory or consulting services. The U.S. Model does not provide for treating those activities as a permanent establishment and accordingly they would generally not be taxed at source. However, in deference to the status of many of the proposed treaty partners, most of the treaties before the committee today contain supervisory or construction services as a permanent establishment.

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[1] United States negotiators start from the United States model income tax treaty (or, in the case of an estate and gift tax treaty, the United States model estate and gift tax treaty), which is a public document prepared by the Treasury Department setting out its preferred position on each article. The model income and estate tax treaties of the Organization for Economic Cooperation and Development (the OECD) and the United Nations model for inocme tax treaties between developed and developing countries are also used as guides.

Developing countries also seek relatively high rates of tax at source on passive income while the United States generally seeks low withholding taxes at source. The U.S. Model calls for 5 percent on direct investment dividends and 15 percent on portfolio investment dividends. The U.S. Model takes the position that interest and royalties should be exempt from tax at source. Developing countries do not want to relinquish source basis taxation and insist on higher rates. In the case of one treaty, Argentina, there is no limitation on interest and royalty taxation at source. Some of the others have very high limits. Israel, for example, will be permitted to impose a 17.5 percent rate of tax on interest. The Philippine Treaty contains some of the highest limitations found in U.S. tax treaties.

While there may be an argument for insisting on adherence to residence basis taxation, most people would seem to agree that such a position would limit our ability to negotiate treaties for developing countries. To the extent that treaties with developing countries are desirable the concessions are probably necessary. The committee may wish to determine whether guidelines are appropriate.

A significant advantage of treaties with developing countries is the ability of the parties to exchange tax-related information. An expanded treaty network could also generally help the tax administrators to better administer the treaties.

B. Competent authority

Income tax treaties contain a provision commonly called the Mutual Agreement Procedure article which provides that the competent authorities of the countries (the IRS and the foreign tax authorities) can consult to deal with cases which give rise to double taxation under the convention and also develop procedures and interpretations to attempt to avoid double taxation. A number of the treaties (Argentina, Bangladesh, Canada, Denmark, Jamaica, and Malta) contain a provision which allows that competent authorities to consult together ". . . for the elimination of double taxation in cases not provided for in the Convention," Similar provisions are contained in the existing treaties with Hungary and Poland as well as the U.S. Model and the OECD Model. Questions have arisen as to the meaning of this language. Assuming it is intended to permit the tax authorities to make adjustment of tax liability in cases of double taxation that are not specifically covered by the treaty, an issue arises as to whether this is an appropriate delegation of legislative power to the IRS.

Another question is the scope of this provision. Presumably, this authority cannot be exercised to affect items of substance outside the scope of the treaty. It has been said that it is to be used to resolve noncontroversial items which are within the general scope of the treaty but which are not adequately dealt with by the treaty in some technical respect. Other questions have been raised by commentators as to its appropriateness. [See Jones, John F. Avory, "Mutual Agreement Procedure", Bulletin for International Fiscal Documentation, 556 (1980).] Questions have also been raised as to the validity of the delegation. Questions as to whether a decision under this provision will be binding on the courts or even binding on the competent authority himself have been raised.

Arguably, the provision is too broad on its face and should be appropriately limited. If the committee is concerned, it could recommend ratification with an understanding that the provision is limited to relatively minor technical problems, or it could make clear in the committee report that that is the intended meaning of the provision. It might be useful if Treasury were to submit a statement outlining its views of the scope of the provisions.

A number of the pending treaties would give the competent authorities the right to increase amounts specified in currency. The effect is to permit the competent authorities to increase the amounts individuals must earn before they will be subject to tax in the country where services are performed. The treaties do not contain standards for determining when the amount should be increased, although most do say that economic developments should be taken into account. This is also the first explicit Congressional delegation to the competent authorities (in the case of the United States, in effect, the Assistant IRS Commissioner for Compliance, or his delegate) of the right to set taxing jurisdiction. There is no comparable delegation in the Code. Thus, issues to be considered are whether it is appropriate to delegate this authority to the IRS, and, if so, whether any standards should be articulated by the Senate to provide guidance to the IRS in the exercise of that authority (e.g., any increases in amounts specified in currency in the treaties should be modified only to reflect the impact of inflation).

C. Congressional oversight of competent authority cases

The mutual agreement procedures are important because many cases that involve double taxation that cannot be resolved through the operative provisions of the treaty are resolved through that procedure. Many of these cases are intercompany pricing cases involving substantial revenue. They are resolved by negotiations between the United States and the foreign competent authorities. The result may be a splitting of substantial revenue between the United States and its treaty partner.

All of the treaties contain a provision that limits access to information received by the United States and the treaty partner under the treaty to persons involved in the assessment or collection of taxes. This provision in existing treaties has been interpreted by the IRS as precluding Congressional access, specifically General Accounting Office access, to mutual agreement case files.

Accordingly, the Congressional Oversight Committees, and the GAO at their request, have been hampered in their recent attempts to audit the IRS administration of mutual agreement cases which may involve significant revenue. Treasury has indicated that this problem will be taken care of in future treaties, and that they are attempting to work out the problem for existing treaties. Most of the instant treaties, however, do not contain language that clearly permits Congressional access. The Canadian treaty does contain language which we understand is intended to permit continued access to information obtained from Canada. The issue is the extent to which Congressional oversight should be permitted and, if so, whether some change in the treaty language is necessary to accomplish that objective.

If this issue is of significant concern to the committee, the relevant treaties could be approved subject to an understanding that the Congressional Oversight Committees and the GAO will, pursuant to the procedures established in the Internal Revenue Code, have access to the mutual agreement case files where necessary to carry out their oversight functions. Alternatively, this result might be accomplished by a statement in the committee reports that access is intended to be permitted under these provisions.

D. Nondiscrimination

Most of the treaties contain a comprenhensive nondiscrimination provision providing that neither country can discriminate by imposing more burdensome taxes on nationals of the other country that it imposes on its own nationals in the same circumstances. The scope and the meaning of the nondiscrimination provisions are not clear in several respects. As a consequence, it is not clear what, if any, provisions of U.S. law are (or are intended to be) overriden by this provision.

(1) Foreign investors in U.S. real estate.—One area of particular concern is whether the nondiscrimination provision overrides the recently enacted legislation which is intended to subject foreign persons to capital gains tax when they sell United States real property. An argument could be made that the basic structure of that legislation technically violated the nondiscrimination provisions of certain existing U.S. tax treaties. In order to prevent foreign investors from taking the position that this arguable technical conflict relieved them from tax liability under the legislation, the legislation specifically overrode the existing treaties on this point to the extent, if any, that a conflict existed and provided an exclusive remedy under the statute. While this statutory relief provision resolves the possible conflict with respect to existing treaties, the problem can arise under the pending treaties since they will be ratified after the legislation was enacted and thus, to the extent of any conflict, might be held to supersede it. We understand that Treasury takes the position that these treaties do not conflict with the legislation.

We recommend that the committee clearly specify the relationship between the nondiscrimination provisions of the proposed treaties and the real estate legislation. More particularly, we recommend that the committee should take the position that the real estate legislation would not be overriden by the nondiscrimination provisions and that this position should be reflected by approving the treaties subject to an understanding stating that position or by including a statement in the committee report to that effect.

(2) Deduction for U.S.-source dividends.—An issue has also been raised as to whether the nondiscrimination rules give a foreign corporation the dividends received deduction given to U.S. companies. An argument has been made that under the nondiscrimination provision a foreign corporation is entitled to the Code dividends received where stock of a domestic corporation paying the dividend is owned by a U.S. permanent establishment of the foreign corporation. Under the Code, a U.S. corporation is allowed a deduction equal to the amount of dividends it receives from a subsidiary. The taxpayer's argument is that the nondiscrimination provision requires that it not be taxed in a more burdensome manner than U.S. companies in

the same circumstances. Not permitting them the full dividends received deduction subjects them to more burdensome tax, they argue. If the taxpayers were to prevail, a significant and apparently unintended benefit would accrue to foreign corporations resident in treaty countries. We understand that it is the view of the Treasury Department that the nondiscrimination provision is not intended to grant the dividends received deduction to U.S. branches of foreign corporations.

We recommend that the committee make clear the relationship of the nondiscrimination provisions of the proposed treaties and the dividends received deduction of the Internal Revenue Code. More particularly, we recommend that the treaties not be interpreted as granting the exclusion and that this interpretation be made clear either in an understanding accompanying the Senate's approval of the treaty or in the report of the committee.

(3) Acquiescence to discriminatory practices.—Another side to the issue of the appropriate level of nondiscrimination is the question of whether the United States should demand a broad based nondiscrimination article, or, alternatively, agree to some exceptions from the nondiscrimination provisions.

The U.S. model nondiscrimination provision generally prohibits the parties to the treaty from discriminating against similarly situated residents of the other country or against their own corporations that are owned by residents of the other country. Most of the treaties contain the model nondiscrimination provision. One major reason for entering into a treaty with a developing country is to obtain nondiscrimination protection.

However, a few of the treaties contain specific provisions which permit discrimination. These are usually inserted into the treaty at the insistence of the developing country. The Philippine Treaty, for example, would permit the Philippines to grant certain tax incentives to Philippine residents but not to U.S. residents. Also, the Philippine Treaty and thus its nondiscrimination provision, does not apply to income from air transport. The airline industry views this as permitting the Philippines to continue discrimination taxation of U.S. airlines. The Jamaican Treaty on its face appears to permit some limited discrimination vis-a-vis U.S. insurance companies.

There seems to be unanimity that it is proper to seek complete nondiscriminatory coverage. Realistically, however, the United States as a developed country may have to permit at least some limited discrimination involving protection of local industry or incentives to residents of the other countries to invest locally if it is to enter into income tax treaties with developing countries. If the committee should decide that nondiscrimination is an overriding policy issue it could reserve on those provisions which permit some discrimination. In the alternative, it might recommend ratification of the present treaties but with a clear statement in its report to the Senate of its view that future treaties not contain discriminatory provisions. Of course, either action might significantly restrict the expansion of the treaty network to include more developing countries.

E. Deductions—Expansion of the scope of the treaties

Three of the treaties before the committee, the treaty with Canada and two of the treaties which are the subject of hearings this afternoon (those with Israel and Jamaica) contain provisions which permit U.S. persons to take U.S. tax deductions to which they would not otherwise be entitled. The issue is whether the U.S. taxation of U.S. persons is inherently a matter which should not be resolved through bilateral agreements without specific legislative approval.

Both the Israeli and Canadian treaties contain a provision which, on a reciprocal basis, permits a U.S. person to treat as a charitable contribution a contribution to a charity of the other country. The amounts are limited to a percentage of adjusted gross income from the other country. A similar provision is contained in the existing treaty with Canada. As a general rule, treaties have not given U.S. persons deductions for activities related to the other country. Arguably, the situations with Canada and Israel are unique because of the special relationship with the two countries and the special interest which U.S. residents have in charitable activities in the other country.

Two of the treaties (Jamaica and Canada) contain a provision which permits U.S. persons to deduct the expenses of attending a convention in the other country. Under provisions of the Internal Revenue Code (Code sec. 274(h)) adopted in 1976 and modified in 1980, U.S. taxpayers are generally not allowed deductions for attending business conventions outside the United States, its possessions, Canada, and Mexico unless it is as reasonable to hold the convention outside that North American area as within it. The provision in the Canadian Treaty was negotiated before the legislation which gave the convention deduction for conventions in Canada was enacted at the end of 1980.

The recently negotiated protocol to the pending Jamaican Treaty would expand the North American area exception to the U.S. foreign convention expense rule and would thus permit Americans to deduct expenses of attending a convention in Jamaica.

The issue is whether treaties should be used to allow U.S. persons deductions to which they would not otherwise be entitled. Arguably, this is an appropriate function of treaties in limited cases because it adjusts U.S. rules to take into account the tax relationships between the countries. Also, it is the type of provision for which a significant identifiable concession may be obtained. For example, in the Jamaican protocol in return for the convention deduction the United States obtained the tightest anti-treaty shopping provision in any treaty and also a commitment from Jamaica to enter into negotiation of a criminal mutual assistance treaty.

The committee might want to make a clear statement in its report of its view that deductions should be allowed by treaty only in very limited circumstances.

F. Foreign tax credits

The treaty generally provides for relief of double taxation which is not otherwise eliminated by the other rules of the treaty. The United States generally agrees to relieve double taxation by granting a credit for income taxes paid to the treaty partner. The credit is given subject to the limitations contained in the Internal Revenue Code.

In most cases, the treaties provide that taxes which would be creditable under the Internal Revenue Code in any event are creditable. In that case it is unnecessary for the taxpayer to rely on treaty rules for his credit. In some cases, however, credits are given for taxes that are of questionable creditability under the Code rules but whose economic substance is sufficiently comparable to U.S. notions of what constitutes income tax that it does not require a major departure from applicable Code policy to treat the tax as a creditable tax. These cases often solve otherwise difficult technical problems in trying to determine whether a foreign tax system specifically and absolutely fits within our concept of income tax.

Forced loans.—In a few cases, however, the United States has granted foreign tax credits for taxes that would clearly appear not to be creditable under the Code. An obvious example in the treaties before you is the granting of a credit for forced loans required by Israel and Morocco. In both cases the United States is required to allow a foreign tax credit for loans which U.S. businesses operating in the country are required to make to the Israeli or Moroccan Government. The provisions provide that a repayment of the loan is treated as a refund of foreign tax to the U.S. business, and thus the taxpayer's creditable foreign taxes would be reduced in the year of repayment. In practical effect, these provisions amount to a loan from the U.S. Government to the Moroccan or Israeli Government, as the case may be, with a taxpayer acting as a middleman. In the case of Israel the loans are being phased out. We understand that Morocco still has a loan provision. These provisions in effect are an indirect form of loan from the U.S. Government through the tax system.

The committee might want to consider reserving on these provisions. Alternatively, in light of the fact that these treaties were signed a number of years ago, the committee may wish to approve the treaties with the provisions but expressing strong concern with similar provisions in the future.

Oil taxes.—Another issue that is raised by at least two of the treaties before the committee is the question of the appropriate limitation on a foreign tax credit granted under the treaty.

As a general rule, the United States permits a foreign tax credit which is limited to U.S. taxes imposed on foreign source income of a U.S. taxpayer. The limitation is a worldwide limitation which is a ratio of the taxpayer's foreign income to worldwide income. Both the Norwegian Protocol and the proposed Canadian Treaty contain a provision which would limit the credit granted under the treaty to U.S. taxes imposed on income from the treaty partner rather than on a worldwide basis. However, the limitation under the treaty only applies if the tax is otherwise noncreditable. If it is creditable under the Code, then the normal foreign tax credit limitations apply.

The treaties are thus getting involved in a long-standing debate over what is an appropriate tax credit, particularly where mineral taxes are an issue. Some have questioned whether the treaty process is the appropriate place to negotiate a different set of rules than the Code imposes. Some might question the policy of determining an income tax to be creditable by treaty where the Treasury regulations throw doubt on that creditability. It might be argued that in order to obtain a fair result for U.S. taxpayers, the United States is forced into concessions it would not otherwise have to make. Some have seriously questioned whether the treaty process is really the forum in which to consider the foreign tax credit issue. It has been argued that the availability of the foreign tax credit to a major U.S. industry should not depend on whether or not the United States has a treaty with a particular country.

G. Third country use of treaties

Tax treaties are generally intended to limit double taxation of residents of one country which arises because of operations or investments of the treaty partner. At times, however, residents of third countries which may not have treaties with the United States may establish a corporation in a treaty country through which they route their investment in the United States and obtain a lower treaty rate. This planning device is known as treaty shopping. This issue was clearly drawn in the case of the proposed treaty with the British Virgin Islands. Under the existing treaty, which is an extension of the 1945 United States-United Kingdom income tax treaty to former British colonies, U.S. source royalties can be paid to BVI investors free of U.S. tax and dividends paid at reduced rates of tax. By special arrangements, interest also can be paid out free of tax. Under the proposed BVI treaty foreigners resident in any country would have been permitted to invest in the United States and pay a 15-percent rather than the 30-percent gross statutory rate of tax on that investment. Little, if any, investment affected by the treaty would originate in or be destined for the British Virgin Islands. A similar issue was raised with respect to Cyprus because of its status as a tax haven. Principally on account of this issue, Treasury has requested that the BVI and Cyprus treaties not be considered at this hearing.

The present treaty with Jamaica, as amended by the protocol, contains a very strong anti-treaty shopping provision. In effect, Jamaican companies owned by persons who are not residents of Jamaica would not be entitled to treaty benefits unless they could establish that the company was not established to take advantage of the treaty.

The question of the treaty shopping does not arise solely with respect to tax havens that are small countries. An issue has arisen in connection with the ratification of the Canadian Treaty. Much of the Canadian investment in the United States apparently flows through the Netherlands. This is because under the United States-Netherlands Treaty dividends can be paid to the Netherlands subject to a 5-percent rate of tax rather than the 15-percent rate provided for in the United States-Canadian Treaty. Under the new Canadian-Netherlands Treaty, dividends can be paid in certain cases from Netherlands holding companies in Canada at a zero rate of tax. Accordingly, dividends flowing from the United States through the Netherlands and into Canada can incur a rate of tax of 5 percent rather than 15 percent. Should the proposed United States-Canadian Treaty be ratified, the rate for direct investment dividends between the United States and Canada would be reduced to 10 percent but this will still be 5 percentage points higher than the rate that can be achieved through the Dutch connection. [This issue was also discussed in our statement submitted to the Committee in its hearings on the proposed Canadian treaty.]

For a variety of reasons, it may not be desirable to attempt to resolve all these issues in the context of the pending treaties, some of which have been under consideration for a number of years. However, the committee might want to consider directing the Treasury to review its positions on a number of these issues raised by us and by the Treasury in its testimony.

H. Impact of treaties on real property legislation

On November 26, 1980, Congress passed the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), which generally subjects foreign persons to U.S. tax on sales of U.S. real estate made after June 18, 1980. Also, foreign persons selling stock in a U.S. corporation having 50 percent or more of its gross asset value comprised of U.S. real property interests will be subject to U.S. taxation. Finally, the distributions (liquidating or nonliquidating) of a U.S. real property interest by a foreign corporation will be subject to tax.

While the provision was effective for dispositions after June 18, 1980, special rules apply to transactions covered by a treaty of the United States. In general, the Code provision overrides treaties but not until January 1, 1985. If a treaty is negotiated and signed before 1985, the old treaty takes precedence over the Code provision for the period set out in the new treaty or an accompanying exchange of notes, but only for a maximum period of 2 years after the new treaty is signed. The legislative history to the Act indicates that the old treaty is given a 2-year grace period in order to permit the Senate adequate time to consider the revised treaty.

The Economic Recovery Tax Act of 1981 amended this provision to make it clear that the 2-year period did not apply if the new treaty was signed before January 1,

1981. In that case, the old treaty would continue to apply until December 31, 1984, or, if earlier, until the new treaty is ratified.

The treaties before the committee generally do not conflict with the 1980 legislation in its most important respects. Also, they retain the right of the United States to impose relevant reporting or withholding requirements. However, a number of the treaties contain at least two provisions which would restrict to some degree the right of the United States to apply its legislation.

First, under the legislation a foreign investor is taxed on his dispositions of a United States real property holding company. A corporation is a United States real property holding company if the fair market value of its United States real property interest equals or exceeds 50 percent of the fair market value of its total assets. During the consideration of the legislation, the decision was made to include United States real property in which the business of the entity is carried on as United States real property for purposes of determining whether or not the corporation meets the 50 percent test. The treaties with Argentina and Canada, however, contain a different rule. For purposes of determining whether an entity's assets consist principally of real property under those treaties, property in which the business of the entity is carried on is not treated as real property. This change would make it possible for a foreign investor to make substantial investments in U.S. real estate used in a business and, assuming the asset mix were managed properly, significant nonbusiness U.S. real estate investments without being subject to the legislation.

Second, under the legislation, a foreigner disposing of an interest in a partnership, trust, or estate will be treated as disposing proportionately of its U.S. real property. Accordingly, a foreign partnership disposing of an interest in a partnership, 35 percent of the assets of which consisted of U.S. real estate, would be taxed on his gain equal to 35 percent of the gain of the disposition.

I. Second withholding tax

Under U.S. law, dividends received by a foreign person from a foreign corporation are U.S. source dividends subject to the 30-percent withholding tax if at least 50 percent of the gross income of the corporation, in the prior 3-year period, was from a U.S. business of the foreign corporation. This provision is intended to preserve the U.S. withholding tax on dividends in those cases in which a foreign, rather than a domestic, corporation is used to do business in the United States. A number of the treaties preserve this tax. However, a number of the treaties provide that the United States may impose its tax on dividends from a foreign corporation to a resident of the treaty partner only if the profits of the corporation equal or exceed 50 percent of its gross income. This comparison of profits to gross income in effect makes the provision inapplicable. It is understood that it was a technical drafting error and not intended.

We recommend that the approval of these treaties be made subject to an understanding that the provision is to be interpreted in a manner similar to the Code.

We will now turn to the specific treaties before you. In light of the materials which have already been made available we will focus on the significance of the individual treaties and briefly mention the issues raised by them if any.

INCOME TAX TREATY (AND PROTOCOL) WITH ARGENTINA

The proposed treaty is important because if ratified it would be our first treaty with a South American country. This treaty, therefore, could represent an important breakthrough. However, in order to reach agreement, the United States found it necessary to make significant concessions to source basis taxation.

Source basis taxation.—The treaty generally does not provide a reduction in source basis withholding taxes on interest and royalties paid to residents of the other country. In addition, royalties include film rentals, with the result that Argentina can continue to tax film rentals at its current 22.5 percent of the gross payment, or can increase that tax. Generally, the U.S. position (which is rarely achieved) is that these taxes should be eliminated, and many treaties limit the taxes to 10 percent. In the case of interest paid to banks, many U.S. treaties actually achieve a zero rate of tax.

The proposed treaty provides that the countries will limit their withholding tax to 20 percent of the gross amount of dividends paid to residents of the other country, with a special rule in the case of dividends paid by an Argentine company aimed at limiting the combined level of corporate level and dividend withholding tax to 45 percent. Unlike many other U.S. treaties, there is no distinction between portfolio investors and corporate direct investors. In most treaties, the withholding tax on dividends paid to direct investors is lower than the tax imposed on dividends to portfolio investors. Furthermore, the 20 percent rate is higher than generally allowed in U.S. tax treaties which are for the most part with developed countries. In the U.S. model, the rates are limited to 5 percent for direct investors and 15 percent for portfolio investors.

The provision dealing with the definition of a permanent establishment is slightly different than many other U.S. treaties, although generally consistent with treaties with developing countries. In general, it provides for a six-month test for building and construction sites to be treated as a permanent establishment rather than the one-year period usually provided.

To some degree, these concessions to source basis taxation reflect Argentina's territorial tax system which relies solely on source basis taxation for revenue; that is, it does not tax any foreign source income. Nevertheless, these concessions could be viewed as precedent by developing countries many of whom, in practice, also rely solely on source basis taxation.

In the view of some, the United States will not be able to enter into treaties with many developing countries, particularly those in South America, unless we agree to extensive taxation at source. Others have argued that if Congress sends a clear signal that it will not approve treaties without relatively substantial limitations on source basis taxation, then some of these countries will enter into treaties closer to the U.S. position.

Territorial tax system.—This treaty raises several unique issues because Argentina is one of the very few countries that has a strict territorial tax system, and this would be our first treaty with a country having such a tax system. The first issue is whether it is appropriate to forego U.S. tax when, because of the general tax system of the treaty partner, the result will be the total elimination of any tax paid by the foreign investor on that U.S. source income. In the case of this treaty, total elimination can occur in only a few cases.

One way in which treaties attempt to avoid having an item of income taxed by both the source country and the residence country is to have the source country cede jurisdiction to tax the income to the residence country. This rational breaks down where the residence country exempts the income. In our treaties with countries having remittance basis taxation of certain types of income (the country does not tax certain types of income earned abroad by its taxpayers until and unless it is repatriated), the United States has generally insisted on a provision denying U.S. rate reductions and exemptions for income which is not remitted to, and thus subject to tax by, the treaty partner. At issue is whether a similar limitation is appropriate here.

Anti-treaty shopping provision.—This treaty is one of two treaties (the other is the treaty with the Philippines) before the committee that does not contain an anti-treaty shopping provision. Most recent U.S. treaties contain a provision that limits the use of the treaty to corporations controlled by persons who are residents of the treaty partner. These provisions are intended to prevent third country residents from establishing a company in a treaty partner in order to take advantage of reduced withholding rates (i.e., "treaty-shopping"). While withholding rates on interest and royalties are not reduced under this treaty, and while the withholding rate on dividends is relatively high, Argentina's territorial system might raise the potential for other abuses.

While the Article that covers other income might cure some of these problems, the potential for abuse under the treaty, given Argentina's strict territorial system, is unclear. Also, experience has shown that if abuses develop later it is very difficult to negotiate solutions. As indicated above, the Committee might consider certain limitations if it considers this potential sufficiently serious. It must be recognized, of course, that insistence by the United States on anti-abuse provisions might result in the refusal of Argentina to accept the treaty.

INCOME TAX TREATY WITH BANGLADESH

The proposed treaty is not controversial. It contains developing country concessions similar to those in other treaties before the Committee. In fact, they are not as extensive as some.

One provision that should be brought to the Committee's attention is the shipping and air transport provision. Generally, the U.S. seeks a complete exemption from taxation at source for income from shipping and air transport. The proposed treaty exempts international airline income from tax. It does not, however, exempt shipping income. The U.S. model, and most U.S. treaties, contain a source exemption for both aircraft and shipping. The issue is whether the United States wants to establish the precedent of a treaty without an exemption for shipping income.

As is the case with Malta, the proposed treaty raises the issue of the expansion of our treaty network to jurisdictions with which the United States has only minimal economic contacts.

We are not aware of any opposition to the proposed treaty.

INCOME TAX TREATY WITH EGYPT

The proposed treaty is similar to recent U.S. income tax treaties and to the U.S. and OECD models. It contains some concessions to source basis taxation in recognition of Egypt's status as a developing country. It contains no major provisions which warrant the special attention of the committee.

The treaty does contain a special provision imposing limitations on taxation of dividends paid by Egyptian corporations to residents of the United States which differ from those ordinarily found in U.S. tax treaties. The differences reflect Egypt's corporate system under which dividends distributed out of the current year's earnings are deductible. The provision is explained more fully in the pamphlet describing the Egyptian treaty under the discussion of the dividend article.

Also, the proposed treaty would apparently permit a relatively minor form of discrimination. Egypt grants a tax exemption to certain businesses that make investments in Egypt. The exemption is generally applicable if the Egyptian corporation is controlled by a foreign corporation. The tax exemption is not applicable if the Egyptian corporation is controlled by foreign individuals who are residents of a country which will tax the income when the shareholders receive it as dividends. The United States does tax the dividends and therefore it would appear that Egyptian companies owned by individuals who are U.S. residents will be discriminated against when compared to residents of other countries. This is a relatively minor issue as few U.S. individuals own Egyptian companies.

INCOME TAX TREATY (AND PROTOCOL) WITH ISRAEL

The proposed treaty is similar to recent U.S. income tax treaties and to the U.S. and OECD models. It contains some concessions to source basis taxation similar to those contained in a number of the treaties before the Committee. In general, we are not aware of any significant controversy concerning the treaty. However, the treaty does contain a few provisions that are worthy of note, and one, the forced loan provision, that might prove troublesome

Forced loans.—As in the case of the treaty with Morocco, this treaty would require the United States to treat as income taxes certain loans which a U.S. business operating in Israel is required to make to the Israeli Government. Thus, those U.S. businesses not in an excess foreign tax credit position would be allowed a foreign tax credit for the amount of the loan. However, a repayment of the loan will be treated as a refund of Israeli tax to the U.S. business, and thus the taxpayer's creditable foreign taxes would be reduced in the year of repayment. As a practical matter, this amounts to a loan from the U.S. Government to Israel, with the taxpayer as the middleman. This treatment is accorded only to corporations which become subject to the loan requirement before Arpil 1, 1977, but only if levied for taxable years ending before April 1, 1988. We understand that the Israeli Government no longer requires loans.

If this provision should give rise to concern, the Committee might want to consider recommending approval with a reservation. However, in light of the long period of time that the treaty has been here, and also considering the fact that Israel no longer requires the loans, the Committee might, instead recommend approval but with an indication that in the future provisions of this type will not be approved. In that event, the committee may consider it appropriate to limit the foreign tax credit to the U.S. tax on Israeli source income.

Dividend.—The dividend rates are not reciprocal in certain tax holiday cases. Dividends on a direct reinvestment in an Israeli corporation subject to a tax holiday are taxed at a 15-percent rate while dividends on a direct investment in either a U.S. corporation or an Israeli corporation not subject to a tax holiday would be taxed at a 12.5 percent rate. Dividends from portfolio investment are taxed at a 25-percent rate, which is high when compared to other treaties before the Committee.

Interest.—The treaty permits. 17.5-percent rate of tax at source on payments to persons other than banks, insurance companies, or governmental units. The rate for payments to financial institutions, which generally have the greatest problems, is 10 percent. The 17.5-percent rate is the highest agreed to by the United States in any treaty and might establish a precedent for negotiations with other countries. However, the Argentine treaty would not limit source basis taxation of interest. We understand that Treasury would not have agreed to such a high rate without the lower rate for interest paid to financial institutions.

Charitable contributions.—On a reciprocal basis, the protocol to the treaty would permit a U.S. person to deduct as a charitable contribution a contribution to an Israeli charitable organization. In the case of an individual, the amount treated as a contribution (which is subjected to U.S. Code limits) cannot exceed 25 percent of adjusted gross income from Israeli sources (25 percent of taxable income for a corporation). A similar provision is contained in the existing Canadian treaty and the pending revision of that treaty. The issues raised by this provision, and possible actions with regard to it are discussed in more detail in the general section of our testimony.

Exchange of information.—An exchange of notes makes clear that due to resource and technical problems Israel cannot, at this time, provide routine information as to U.S. recipients of dividends, interest, and royalties from Israel. They have agreed to provide the United States with this information as soon as possible. This type of information is normally received from treaty partners, and is supplied to them by the IRS. The failure to receive this information would make it more difficult for the IRS to detect such amounts that may not be reported. We are, of course, better off in this regard with a treaty than without one. Also, information on specific cases will be supplied by Israel.

Exchanges of information are a primary purpose for entering into a treaty. Routine information can be useful to the IRS in determining whether U.S. persons receiving income from the treaty partner are reporting all of their taxes.

If the Committee is concerned about the inability of Israel to supply this information it might, in its report to the Senate, express its concern. It could suggest that the Treasury monitor the situation closely to ensure that routine exchanges of information are commenced as Israel's capabilities in this area develop.

INCOME TAX TREATY (AND PROPOSED PROTOCOL) WITH JAMAICA

The proposed treaty generally follows the U.S. and OECD models, but it contains a number of provisions that vary from those models and many U.S. income tax treaties. The treaty itself is not controversial. However, the protocol presents an issue which has generated some controversy.

Less developed country concessions.—A number of these provisions generally reflect U.S. concessions to Jamaica because it is a developing country. For example, the definition of permanent establishment is somewhat broader than that in the U.S. model and many existing U.S. treaties. The principal areas in which the proposed treaty departs from the U.S. model are the inclusion as a permanent establishment of a place of management, a store or sales outlet, construction projects or drilling rigs or ships lasting in the country more than 183 days in a 12-month period (rather than the model 12 months), performing services through personnel for more than 90 days, and the maintenance of substantial equipment for more than 120 consecutive days. Also added is the inclusion in the time period for a construction-type project of connected supervisory services.

Furthermore, the limitations on withholding taxes are higher than those in the model. The tax on direct investment dividends is limited to 10 percent in contrast with the 5 percent in the U.S. model.

The U.S. accumulated earnings tax will not apply to certain income of a Jamaican company derived under Jamaican tax incentive legislation. The tax at source on gross interest is limited to 12.5 percent rather than the zero rate in the U.S. model. Royalties, including movie royalties, may be taxed at 10 percent of gross rather than the zero rate in the U.S. model. The zero rate is rarely obtained. Independent personal service income may be taxed if the person is present in a country for more than 90 days, in contrast to the U.S. model which requires presence for more than 183 days. Both dependent and independent personal service income may be taxed at source if the income exceeds a dollar threshold. The U.S. model does not contain a dollar threshold.

The United States may not impose its so-called second withholding tax on dividends paid by Jamaican corporations earning significant business profits in the United States.

Foreign conventions (Protocol).—One provision which might be controversial is that in the protocol to the treaty which allows U.S. persons a deduction for expenses of attending business conventions in Jamaica.

As was explained in our discussion of the broader issues, under provisions (Code sec. 274(h)) adopted in 1976 and modified in 1980, U.S. taxpayers are generally not allowed deductions for attending business conventions outside the United States, its possessions, Canada and Mexico, unless it is "as reasonable" to hold the convention outside that "North American" area as within it. The recently negotiated protocol to the pending treaty would expand the North American area exception to the U.S. foreign convention expense rules and would thus permit Americans to deduct expenses of attending a convention in Jamaica. This granting of a deduction otherwise denied represents an expansion of the general scope of treaties which usually seek only to minimize double taxation. It raises the issue of the extent to which we should give U.S. tax benefits to Americans under treaties. This issue is drawn with particular acuteness in the instant situation in view of the fact that only last year Congress considered the question of whether an exemption should be extended to the Caribbean countries and Congress rejected that approach. The Jamaican protocol does contain a significant quid pro quo in the form of the strongest anti-treaty shopping provision in any U.S. income tax treaty and a commitment from Jamaica to negotiate treaties on extradition and mutual legal assistance on criminal matters.

This provision is evidently of concern to certain U.S. interests in the tourism industry because it removes a competitive advantage. Also, placing the provision in this treaty establishes precedent for other negotiations. It might be hard to resist giving the provision to other countries, even European countries, once they too are willing to include anti-treaty shopping rules in the treaties.

If the Committee is sufficiently concerned with the provision, it could, of course, recommend that the treaty be approved and that the protocol be approved with a reservation on the convention point. It is, however, likely that Jamaica would refuse to approve the protocol with a reservation, and it could reject the treaty. Alternatively, the Committee might want to recommend approval of the treaty and protocol but with a recommendation that the Treasury not negotiate such provisions in the future, or with guidelines to the Treasury as to the cases where such a conversion would be appropriate.

Anti-treaty shopping provision (Protocol).—The proposed protocol to the proposed treaty contains the broadest anti-treaty shopping provision found in any U.S. income tax treaty. In effect, Jamaican companies owned by persons who are not residents of Jamaica will not be entitled to treaty benefits unless they can establish that the company was not established to take advantage of the treaty. This type of provision would appear appropriate when dealing with a smaller country that is or has the potential to become an offshore banking center or tax haven.

Some concern has been expressed that inclusion of this provision will encourage other countries to put similar provisions in their treaties, and that this will foreclose opportunities to lower taxes on international transactions. On the other hand, others take the view that limiting treaty shopping will encourage more countries to enter into treaties directly with the United States. Also, as discussed above, countries such as Canada will be more willing to make concessions to the United States if their companies cannot, by routing their U.S. investments through countries such as the Netherlands, avoid the high rates which Canada insists on imposing on U.S. investors under the U.S.-Canada tax treaty.

INCOME TAX TREATY WITH MALTA

The proposed treaty with Malta contains no major provisions which warrant special attention of the Committee. The proposed treaty is in virtually every respect similar to recent U.S. income tax treaties and the model income treaties of the United States and the OECD. It does contain some developing country concessions similar to those contained in other treaties before the Committee.

The treaty does contain a provision designed to give U.S. shareholders of Maltese corporations the benefit of Malta's integrated corporate tax system.

INCOME TAX TREATY WITH MOROCCO

The proposed treaty is similar to recent U.S. income tax treaties and to the U.S. and OECD models. Because it was negotiated a number of years ago, it differs somewhat in form from recent treaties and the current models. The proposed treaty does contain some developing country concessions similar to those in other treaties before the Committee. It has only one special provision which warrants the attention of the Committee.

Forced loans.—As discussed in our statement on foreign tax credit issues, the proposed treaty contains a provision that is similar to the provision contained in the Israeli treaty and would require the United States to allow a foreign tax credit for loans which U.S. businesses operating in Morocco are required to make to the Moroccan government. Like the Israeli provision, this forced loan rule can be viewed as a loan from the U.S. government to Morocco, with the taxpayer the intermediary. While similar to the provisions contained in the proposed treaty with

Israel, it will have a more significant impact here because the forced loans are still required by Morocco. Also, the Moroccan treaty contains a per country limitation of the foreign tax credit, and accordingly, the loan can only offset U.S. tax on Moroccan income.

As suggested above, the Committee may wish to consider whether this provision is appropriate in an income tax treaty. As an alternative to a blanket reservation on this provision, this provision could be subject to a "sunset" similar to that contained in the Israeli provision. Also, the Committee may wish to consider whether it would be appropriate to allow the credit for Moroccan forced loans, if approved (with or without a sunset), only against U.S. tax on Moroccan income.

PROTOCOL TO INCOME TAX TREATY WITH NORWAY

The proposed protocol to the existing income tax treaty with Norway deals with issues which arose since that treaty came into force. The timing of the ratification of the protocol is important because of the provisions of the protocol dealing with the foreign tax credit for Norwegian offshore Petroleum Taxes will apply retroactively to the six years preceding the year in which the instruments of ratification are exchanged. Accordingly, if the protocol is ratified this year, the credit provisions will apply for 1975 and thereafter. If it is delayed it will not apply to 1975.

Petroleum Tax Act.—In 1975, Norway introduced a tax on petroleum-related activities on the Norwegian continental shelf (PTA). The main feature of this Act was the addition to the generally applicable corporate tax of an additional tax of 25 (now 35) percent of the taxpayer's income computed under Norwegian law. The details of this law are described in the pamphlet (pp. 4-6). The protocol would amend the existing treaty to treat this tax and the other generally applicable Norwegian corporate taxes as creditable taxes for U.S. foreign tax credit purposes.

No determination has been made by the U.S. Treasury or Internal Revenue Service concerning the creditability or noncreditability of Norway's national or municipal income taxes of the Special Tax as such under the PTA. Questions such as whether the Special Tax is a creditable income tax under general U.S. Internal Revenue Code concepts or whether it is a substantially similar tax to those creditable taxes enumerated in paragraph (1)(b) of Article 1 of the present treaty or whether the national and municipal taxes as modified and applied under the PTA remain creditable under Article 23 have not been resolved administratively or judicially. However, under the Treasury's proposed and temporary foreign tax credit regulations, as presently drafted, it would appear that at least certain of these taxes would not be creditable. The protocol provides that these taxes are creditable, subject to the limitations contained in the proposed protocol.

In addition to the general rules found in tax treaties, the proposed protocol would permit the taxes covered by the PTA to offset only U.S. taxes on Norwegian oil and gas income. A limited carryback land carryforward of taxes not used in the current year is also provied for. A similar provision is contained in the third protocol to the U.S.-United Kingdom treaty. There was a threatened reservation on the provision in that treaty making the U.S. Petroleum Revenue Tax creditable. In response, a per-country limitation was inserted in the treaty.

The issue is the extent to which treaties should be used to provide a credit for taxes that may not otherwise be creditable and in cases where the treaty does provide creditability, to what extent treaties should impose limitations not contained in the Code. Also at issue is whether the highly controversial area of U.S. policy on the tax credits it allows its oil companies on their foreign extraction operations should be established through the treaty process rather than the regular legislative process.

Offshore activities.—Norway would have the right to tax income from offshore mineral-related activities after the activities have taken place for more than 30 days in any 12-month period. Wages resulting to exploration or exploitation of offshore resources would be taxable, but only after 60 days of personal services in any one taxable year. The United States has reciprocal rights to tax, but as a practical matter there is little, if any, Norwegian exploration in the United States. The periods which must elapse before a country may tax this type of income are relatively short, although the same is provided for in the U.K. treaty. Also, without the treaty Norway would tax the income from the first day the activities begin. The issue raised is whether the United States should give up the primary right to tax service income after only a relatively short period of time.

Withholding rates.—The proposed protocol would increase the maximum rate of withholding tax on direct investment dividends from 10 to 15 percent. Under the present treaty the rate is 10 percent on direct investment dividends and 15 percent on all others. Also, the present complete exemption from tax at source for interest would be replaced with a provision permitting a 10-percent withholding tax. However, interest on bank loans, commercial credit, certain government obligations, and debt outstanding at the signing of the proposed protocol would be exempt. Also, interest will continue to be exempt at source unless the other country imposes a tax on interest paid to nonresidents. As Norway does not now impose such a tax all interest would remain exempt from tax. These new rate limitations are higher than those provided for in the U.S. model treaty.

INCOME TAX TREATY WITH THE PHILIPPINES

The proposed treaty with the Philippines contains a few provisions that may be controversial. The treaty is generally similar in form to recent U.S. income tax treaties and to the United States and OECD models, but with significant adjustments to source basis taxation in recognition of the status of the Philippines as a developing country. The proposed treaty was the subject of hearings held by this Committee on July 19 and 20, 1977. Because of opposition from the airline industry, the treaty was never reported.

There are four matters contained in the treaty which we would like to discuss.

Shipping and air transport income.—This is the first U.S. tax treaty which does not provide for the reciprocal exemption of shipping and air transport profits. In the case of air transport profits, the treaty contains no restrictions whatsoever on either country's right to tax income from sources within that country which is earned by residents of the other country. In the case of shipping profits, the treaty limits the tax which may be imposed by either country to 1.5 percent of gross revenues derived from that country (this tax rate limitation on both countries is to be reduced in the event that the Philippines concludes a tax treaty with a third country under which a lower tax rate limitation is established).

The airline industry continues to object vigorously to this failure to provide a reciprocal exemption for airline profits and to other features of the convention.

The airline industry has argued that the United States should not depart from prior treaty policy and accept a provision which permits the other country to tax shipping and aircraft operating income. The tax paid in the Philippines either reduces U.S. tax revenues (to the extent the Philippine tax can be credited by a particular taxpayer against U.S. income tax) or represents an increased cost to U.S. companies doing business in the Philippines (to the extent the U.S. companies have no U.S. tax liability or have excess foreign tax credits without regard to the Philippine tax). In addition, it is argued that other developing countries would rely on this provision as a precedent in attempting to negotiate tax treaties with the United States which do not provide the reciprocal exemption to shipping and air transport income. Nonetheless, at least with respect to shipping income, there has been increasing interest in recent years in moving away from a system of exemptions and the Philippine treaty is consistent with that position.

Perhaps more important than the fact that the treaty does not provide for the complete exemption of shipping and air transport income is that the treaty permits discrimination in the Philippine tax treatment of U.S. companies and their Philippine competitors. The potential for discrimination is different in the case of shippers and airlines.

First, while the Philippines imposes on U.S. airlines a tax equal to 2.5 percent of their gross revenues from Philippine sources plus a corporate franchise tax of 2 percent of the same amount, the Philippine Airlines (PAL) is exempt from that 2.5 percent tax but instead pays a tax of 2 percent on its worldwide gross revenues. At one time there was some dispute as to the actual difference in the Philippine tax burden imposed on income derived by PAL and that imposed on the U.S. airlines on their income from operating into and out of the Philippines. Whatever the differential, it appears that there is discrimination, and it is permitted to continue under the treaty.

It should be noted that the treaty leaves open the option for the U.S. Government to retaliate against this discrimination by increasing the U.S. income tax on Philippine corporations under the antidiscrimination provisions of the Internal Revenue Code (sec. 896). However, given the limited contacts which Philippine aircraft operators have with the United States, it is doubtful that this retaliation would have much impact.

The airlines now may be willing to accept a compromise that treats airline income like shipping income so that it would be taxed at 60 percent of the normally applicable rate, and that makes it clear that certain ticketing activities of independent Philippine agents of U.S. airlines will not result in the Philippines taxing the U.S. airlines as if they earned income through an office in the Philippines. The airline industry would not be completely satisfied, but they have indicated that they would not oppose a treaty containing these provisions. The Philippines have apparently agreed to a similar provision with Japan. The industry most likely will, however, continue to oppose the treaty until the provision is added.

If the committee decides that the failure to provide for the exemption of air transport income presents sufficiently troublesome problems, it could recommend that the treaty be rejected. However, rejection of the treaty will not by itself end the taxation by the Philippines of U.S. airlines.

If the committee decides that the potential for discrimination by the Philippines against U.S. airlines is sufficiently troublesome, it could recommend the adoption of the treaty subject to a reservation on the Shipping and Air Transport provision (Article 9) to the extent it permits this discrimination. It must be emphasized, however, that the Philippines may refuse to ratify the treaty subject to such a reservation.

Alternatively, the committee could recommend that ratification be delayed pending negotiation of a protocol resolving the airline issue.

Another alternative is to recommend ratification of the treaty, but with a recommendation to the Treasury to negotiate relief similar to that contained in the Philippine-Japanese treaty. It is possible that the Philippines might accept such a reservation. If this approach is taken, the committee might also reserve on the termination article and provide that the treaty will terminate within a specified period if a solution has not been achieved.

If the committee does not want to take any of the above actions because it feels that the treaty is sufficiently important that it should be ratified notwithstanding any problems presented by the Shipping and Air Transport provisions, the committee may wish to include a statement in its recommendations emphasizing its concern and strongly urging the Treasury to resist similar provisions in future treaties.

U.S. real estate.—The proposed treaty prevents the United States from taxing a Philippine resident on his income from the sale or other disposition of an interest in a U.S. entity that owned U.S. real estate. As in the case of several other treaties negotiated before the adoption of the 1980 legislation taxing foreign investors in U.S. real property, this provision would, if not limited, override that legislation. It would appear advisable to limit this provision so that it does not override that legislation.

Royalty income.—The withholding tax rates established under the treaty with respect to royalties are not strictly reciprocal. As discussed more fully in the pamphlet describing this treaty, the limitation of the withholding tax imposed by the United States is 15 percent of the gross amount of the royalty. The withholding tax on royalties imposed by the Philippines may not exceed 25 percent except that royalties paid by a corporation registered with the Philippines Board of Investments and engaging in preferred areas of activity are limited to 15 percent. However, these Philippines withholding rates are to be reduced in any case where the Philippines reduces its rates to a lower level in a treaty with a third country.

Reciprocity in withholding rates is one of the basic policies of U.S. treaty negotiation. However, in this case, given the variable withholding rates established for the Philippines and the probability that a substantial part of U.S corporate investments in the Philippines will be subject to the lower 15 percent rate, this provision would seem to raise no serious problems.

Anti-treaty shopping provision.—Of the income tax treaties before the committee, only this one and the treaty with Argentina do not contain a holding or investment company provision intended to limit the use of the treaty by residents of third countries. Almost all of our recent treaties have that provision. It is not clear why it was not included in this treaty.

Even if no abuse is possible at the present time, possibilities may develop later. It has proved difficult to renegotiate treaties to curb abuses.

The committee could recommend that ratification be delayed pending negotiation of an anti-abuse provision. In the alternative, it could recommend ratification with an understanding that the Treasury will negotiate an anti-treaty shopping provision. As support for the Treasury, the committee could recommend a "sunset" reservation under which the treaty will terminate within a specified period if an anti-treaty shopping provision is not agreed to. Another alternative would be to approve the treaty subject to a reservation or understanding imposing an appropriate anti-abuse provision.

ESTATE AND GIFT TAX TREATY WITH THE FEDERAL REPUBLIC OF GERMANY

The proposed estate and gift tax treaty with Germany is intended to limit double taxation of estate and gifts of domiciliaries of the two countries. The treaty is similar in concept to recently ratified treaties with France and the United Kingdom. The treaty generally follows the U.S. model estate and gift tax treaty.

The treaty does not contain any special provision which warrants the attention of the Committee. The treaty is explained in the pamphlet which has been made available to the committee and its staff.

COMPETENT AUTHORITY PROVISION

Mr. TIPSON. Thank you, Richard, very much.

Could we focus for a minute on the issue of competent authority, which you know we have discussed. Would you just outline briefly the provisions in, I take it, all these treaties for competent authorities to work out problems that arise.

Mr. GORDON. Yes, these treaties contain what is called a competent authority provision or a mutual agreement article. All of them do have the general article which basically says that the competent authorities of the two countries can get together to negotiate out cases where double taxation still arises, notwithstanding the convention.

A number of the treaties contain a provision which says that the competent authorities can settle disputes outside of the scope of the treaties. I believe that is the language. We can get the exact language for you.

There is some concern—and this has been written about by at least one noted commentator—as to what that provision means. I guess in its most absurd interpretation, one could say, "Well, does that mean that we could deal with problems of State taxation and other things that really the treaty was never intended to take into account?"

There is significant concern as to how far the competent authority can go, what the meaning of a settlement under that kind of procedure is. We might suggest that the committee request the Treasury Department to define at least what they feel is the scope of that provision in the course of your consideration of the treaties.

Mr. TIPSON. I notice in the Jamaica provision it states: "Any agreement reached shall be implemented notwithstanding the time limits in the domestic law of the contracting states."

Mr. GORDON. That is something a little bit different. That is intended to deal with statute of limitations problems. The problem that it takes a long time to audit cases and sometimes the two systems just do not mesh.

Mr. TIPSON. Are these competent authority provisions in most of our older existing tax treaties, or is this something relatively recent?

Mr. GORDON. They are in most of them. The "beyond the scope" language is not: that is relatively new.

Mr. TIPSON. We negotiated treaties, I am told, with India and Brazil which contain tax-sparing provisions. These provisions were subsequently rejected by the Senate, as I understand it. Is that correct, Dave? I believe so.

FORCED-LOAN PROVISIONS

Do you consider these tax-sparing provisions similar at all to the forced-loan provisions contained in the Morocco and Israel treaties?

Mr. GORDON. Let me ask Mr. Brockway to answer that question.

Mr. BROCKWAY. I guess there are two possible ways of analyzing what the nature of that forced loan provision is. You can either analyze it along the lines of those provisions which clarify what payments to the treaty partner qualify for our foreign tax credit. In a number of previous cases, the determination has been made that an otherwise noncreditable payment is roughly comparable to what is intended as a tax under our system and thus a credit is allowed under a treaty.

Another possible way is to analyze it within the frame of reference of those refjected provisions in earlier treaties that either would have allowed tax sparing or would have allowed an investment credit for investments in those foreign jurisdictions as an incentive for U.S. companies to invest there.

Clearly, a forced loan is not an income tax in the U.S. sense, and it is not really comparable to such a tax. One does not pay tax to the Government and then assume that some period down the line that you are going to get a refund of that tax. On the other hand, while the forced loan provision is designed, in part, as an incentive to do business in the treaty partner; it is not exactly comparable to those earlier situations. Here the taxpayer is making an outlay to the foreign government as contrasted with those earlier situations where the effect of the agreement would have been that there would be no tax paid to either country nor would there be any outlay to either country. So that the forced loan provisions are not directly analogous either to the tax sparing provisions which have been rejected in the past or the foreign tax credit articles which have been approved.

Mr. TIPSON. With everyone's indulgence, I will ask a few more questions, and then submit to you a few questions in writing. We obviously will be in continuing communication on all of these treaties and agreements.

Mr. GORDON. Certainly.

POTENTIAL PROBLEMS

Mr. TIPSON. Let me focus on a few areas quickly.

Richard, you are an authority on tax havens. I think everyone would recognize that. Do you concur with the Treasury's approach to the BVI [British Virgin Islands]?

Mr. GORDON. I am not so much an authority as are some others. I guess the BVI and the Cyprus treaties are certainly worth a second look. Clearly, there are some potential problems. And if I were a new treasury coming in, I would want to take a look to make sure that the antitreaty shopping provisions are adequate.

I guess in the case of the BVI there was a commitment on exchange of information. I might have some concern with exchange of information in the case of Cyprus.

Let me clear up one point on the "beyond the scope" language, for the record. That language is in the OECD model.

Mr. TIPSON. Regarding the Jamaica Treaty, is the antitreaty shopping provision in that treaty the kind of model that you think we ought to adopt?

Mr. GORDON. I think the antitreaty shopping provision in the Jamaica Treaty certainly is worth consideration when you are dealing with smaller countries with limited tax systems and limited tax bases. I do not know that it would necessarily be an appropriate model if you were dealing with a larger developed country. But I certainly can see that it would have some utility.

ARGENTINE INVESTORS

Mr. TIPSON. Let me turn now to the Argentine Treaty. And this will be my last question for you today.

Will Argentine investors pay any taxes on income earned on U.S. investments either to the United States or Argentina under the proposed United States-Argentina Tax Treaty?

Mr. GORDON. Argentine residents who invest in the United States and, for example, get dividends, interest, or royalties would pay U.S. tax, in some cases at a reduced rate.

We do have some concerns with how that treaty would operate when you are dealing with certain types of operations here that may not amount to having a permanent establishment in this country and may kind of fall through the cracks.

There is a problem once again with the real estate provision of the Argentine Treaty which, in some cases, may enable Argentine residents to avoid a U.S. tax. Presumably, they will also avoid tax by Argentina because of its territoriality system. So there are some problems. Once again, there is a unique meshing of systems, and we have some concerns.

Mr. TIPSON. Thank you very much. We did receive today, as Chairman Percy noted this morning, what is essentially a statement of concerns raised by Chairman Rostenkowski of the Ways and Means Committee and your own boss on the Joint Committee on Taxation.

We will do our best during the next few weeks in discussions with them to try to work out some understandings about how to proceed on these treaties. It may not involve changes in these particular treaties, but in any case there will be consultations to decide upon how the process generally can be improved between the tax-writing committees and the Foreign Relations Committee. So we look forward to working with you gentlemen on this.

Mr. GORDON. Thank you.

Mr. TIPSON. Our next panel of witnesses will speak to the Philippines Treaty. We have one witness who, as I understand it, has to catch a plane. Our witnesses are William M. Hawkins, vice president, finance and taxation, of the Air Transport Association of America.

Bill, I understand you have to catch a plane, so we will ask you to proceed first.

We also have Peter J. Finnerty, vice president for public affairs, of the Sea-Land Industries, Inc.

STATEMENT OF WILLIAM M. HAWKINS, VICE PRESIDENT, FINANCE AND TAXATION, AIR TRANSPORT ASSOCIATION OF AMERICA, WASHINGTON, D.C.

Mr. HAWKINS. Thank you very much. I have submitted a statement which I would hope would be accepted for the record. In the interest of brevity, I will summarize.

You already have heard a great deal of the descriptions of the issue in this. I would try to shed a little bit of the airline point of view on this subject.

I noted with interest that eight of the treaties before the committee today are with developing nations. Seven of those treaties contain reciprocal exemption for airline income, one does not. And the 25 or 30 other treaties in force in the United States also contain reciprocal exemptions for airline income in international operations.

The Philippine Treaty does not. As it is before this committee, it does not limit or deal with the taxation of airline income.

This provision was placed in there as a result of the original negotiations where the Philippine Government was not willing to give reciprocal exemption and the airline industry believed it was not appropriate for the United States in its first treaty with a developing nation to break such a precedent and to be the first nation, where the Philippines are a major trading nation, to break such a precedent.

Subsequent to that, the Japanese Government has signed such a treaty with the Philippine Government which does not provide reciprocal exemption and Japan is a major trading nation.

In light of that signing, the airline industry believes that we would not oppose a treaty that would have the 1.5 percent. We would prefer that it be stated in the same manner as the Japanese tax treaty; that is, 60 percent of the rate otherwise applicable.

We also have a concern about discriminatory taxes and the issue of what constitutes doing business in the Philippines for the levy of the tax. We probably are unique in our business with the Philippines, in that we fly directly parallel with or in competition with Philippine airlines. We note from their Internal Revenue Code and their rules that PAL is not subject to many of the taxes to which U.S. airlines are subject.

In my testimony I have enumerated those taxes which we pay and, we believe, we will continue to pay under the treaty. But the competing airlines from the Philippines do not pay them. Now, a treaty is supposed to solve discriminatory problems such as this. And in our opinion, the treaty before you does not solve that.

The third issue is that the Philippine Government has attributed a general sales agent as being a permanent business establishment and thus creating Philippine source income for an airline that does not serve the Philippine but has a GSA there.

Four of our airlines have been visited by the Internal Revenue Service of the Philippines and assessed a tax based upon tickets sold in the Philippines by some other airline and on which the passengers were flown in the United States by these wholly domestic airlines.

We think that the treaty should eliminate that. And as I have summarized in the last part of my testimony, realizing there would be no protection from the discriminatory taxes without a treaty, the airlines have agreed to support a treaty without reciprocal exemption if it were to include the following.

Reduction of the present 2.5 percent tax to 1.5 percent;

A clear and concise understanding that a general sales agent is not a permanent business establishment within the meaning of article 5 of the treaty; and

A clear and concise understanding that the nondiscrimination provisions of the treaty apply to U.S. airlines and to Philippine airlines.

We appreciate the opportunity to present our views, and we would be happy to work with the staff in developing these records further.

Mr. TIPSON. Thank you very much, Bill.

Peter, please proceed.

[Mr. Hawkins' prepared statement follows:]

PREPARED STATEMENT OF WILLIAM M. HAWKINS

Mr. Chairman and members of the committee: My name is William M. Hawkins. I am Vice President-Finance and Taxation of the Air Transport Association of America. On behalf of ATA and its 32 scheduled air carrier members, I would like to express appreciation to the Committee for providing us the opportunity to present our views on the proposed U.S. Philippine Tax Treaty.

On July 19, 1977, we testified in opposition to this treaty because:

It does not include the reciprocal exemption contained in every other U.S. tax treaty, which precludes the double taxation of international airlines;

It permits highly discriminatory Philippine taxation of U.S. international airlines; and,

It creates a far-reaching precedent for application to other U.S. tax treaties, thereby encouraging significantly increased and discriminatory foreign taxation of U.S. international airlines.

At that time we urged this Committee to withhold ratification of the proposed treaty pending further review and appropriate revision of Article 9(2) to include the standard reciprocal exemption for income earned from the operation of aircraft in international commerce.

As we explained in our testimony, reciprocal exemption is a recognized standard for income tax treaties and is contained in the OECD and U.S. Model Income Tax Treaties. It is also recommended by the International Civil Aviation Organization (ICAO), a United Nations organization. Additionally, the reciprocal exemption for international aviation is contained in every other U.S. treaty.

The proposed Philippine Treaty in Article 9(2) states: "Nothing in the Convention shall affect the right of a Contracting State to tax, in accordance with domestic laws, profits derived by a resident of the other Contracting State from sources within the first-mentioned Contracting States from the operation of aircraft in international traffic."

The effect of the U.S.-Philippine Tax Treaty language, is to allow the Philippine Government to continue to tax U.S. airline revenue attributable to Philippine sources at any rate and under any method it decides to impose. Although the treaty uses the term "profits," we understand the Treasury Department recognizes that the Philippine Government intends to continue its present system of taxing U.S. airlines on their "gross Philippine billings" as provided in Section 24(b)(2) of the Philippine National Internal Revenue Code.

Under the present circumstances, without a treaty, U.S. airlines are taxed at the rate of 2½ percent of "gross billings" attributable to operations in the Philippines. By contrast Philippine Airlines is subject only to a tax on their "taxable net income" under Philippine law. This discriminatory practice, which developed in the absence of a treaty with the Philippine Government, would be sanctioned by the United States if the proposed treaty is ratified.

In 1979, the airline industry was asked by the International Tax Council if the industry would reconsider its position on the proposed treaty. The airlines, after reconsideration, re-affirmed their opposition because the tax discrimination by the Philippines would be sanctioned and could be a precedent for future treaties.

Moreover, representatives of the Philippine Revenue Service during 1979 visited airlines in the United States, Canada and elsewhere that do not provide regular service to the Philippines, but who are represented there only by a General Sales Agent (GSA). The purpose of those visits was to explain to the airlines the reasons for efforts to extend the Philippine's gross billings tax to revenues earned by these airlines on tickets purchased in the Philippines. For example, a ticket purchased in

Manila, for service between Los Angeles and New York would be subject to taxation by the Philippine Government if the airline providing the service in the United States has a GSA in the Philippines.

The U.S. airlines serving the Philippines are also subject to a number of additional burdensome taxes which do not apply to Philippine Airlines. These include: 15 percent profits remittance tax; 2 percent common carrier gross income tax; Corporate income tax at regular rates on nontransportation revenues; 6 percent broker tax on commission income; and Documentary stamp tax on airway bills of lading.

These taxes would continue under the proposed treaty. Because of this, the airlines believe that adoption of the proposed treaty would be in conflict with the International Air Transportation Fair Competitive Practices Act of 1974 (Public Law 93-623). Congress enacted that legislation in order to bring to an end a variety of unfair and discriminatory competitive practices, including discriminatory tax practices, against U.S. international airlines by foreign countries.

In 1980, subsequent to the ratification of the Japanese-Philippine Tax Treaty, the International Air Transport Association (IATA) arranged a meeting of the worldwide airline tax community with Philippine Government representatives to explore the possibility of switching income taxes applicable to international airlines from the present "gross billings" basis to a conventional net income tax. U.S. airlines were represented by ATA at that meeting. The position expressed by the Philippine Government at the meeting made evident that the "gross billings" basis for the tax will continue even through the airline effort to effect a switch to net income taxes continues. It was also evident that the Philippine Government would not agree to a treaty with a reciprocal exemption dispite the efforts of the U.S. Department of Treasury to obtain one.

Realizing that there would be no protection from discriminatory taxes without a treaty, the airlines agreed to support a treaty without reciprocal exemption if it were to include the following features:

Reduction of the present 2½ percent tax to 1½ percent (stated in a manner similar to the provisions in the treaty between Japan and the Philippines) with the assurance from U.S. Treasury Department that such a tax will continue to be creditable against U.S. income taxes;

Clear and concise understanding that a General Sales Agent is not a "permanent business establishment" within the meaning of Article 5 of the Treaty.

Clear and concise understanding that the treaty provision regarding non-discrimination apply to the U.S. airlines and Philippine Airlines.

We have been advised that these changes were proposed to and rejected by the Philippine Government. Because of the concern both by airlines serving the Philippines and domestic airlines providing U.S. domestic service on tickets sold in the Philippines, we urge that the proposed treaty not be ratified until appropriate and equitable treatment for airlines, as outlined above is included.

Mr. Chairman, that concludes my statement, I am prepared to answer any questions that you and the Committee may have.

STATEMENT OF PETER J. FINNERTY, VICE PRESIDENT, PUBLIC AFFAIRS, SEA-LAND INDUSTRIES, INC., EDISON, N.J.

Mr. FINNERTY. Thank you very much. I am Peter Finnerty, vice president, public affairs, of Sea-Land Industries, Inc. Sea-Land Service, Inc., our ocean liner affiliate, is the largest container shipping firm in the world. As the only major U.S.-flag carrier in foreign commerce that does not participate in the U.S. Government's operating subsidy program, the Sea-Land group expects to achieve 1981 gross revenues of about $1.6 billion.

Since it started 25 years ago, Sea-Land Service, Inc., has grown to an international system that provides scheduled, fully containerized transportation between 180 locations in 52 countries with 81,000 freight container and 46,000 truck chassis. Sea-Land's ocean fleet consists of 44 U.S.-flag container ships and 18 smaller foreign-flag feeder vessels.

Sea-Land and other American ocean carriers are a major force in the transportation of cargo to and from the Philippines. Proper tax treatment of U.S.-flag shipping is essential to maintain their competitiveness with foreign-flag shipping.

We welcome this opportunity to testify in support of the ratification of the United States-Philippines Income Tax Treaty.

I might indicate that in the past 2 days I have received authority to express that American President Lines and Lykes Bros. Steamship Co., both major American-flag carriers serving the Philippines, also support ratification of the treaty and join me in making this statement.

As you are aware, there is presently no income tax convention in force between the United States and the Philippines. The proposed convention currently before your committee was submitted to the U.S. Senate in 1977. The proposed convention, if ratified, would make the following tax benefits available to U.S. residents.

A reduction in the Philippines withholding tax from 35 to 20 percent on dividends paid to U.S. corporations and a reduction to 25 percent on dividends paid to all other U.S. residents;

A reduction in the Philippines withholding tax from 35 percent to 25 percent on royalties paid to U.S. residents;

Elimination of the 15 percent Philippines branch profits remittance tax currently levied on the branch profits of the U.S. shipping companies operating in the Philippines;

A 40-percent reduction in the Philippines gross receipts tax currently levied on U.S. shipping companies operating in the Philippines.

It must be emphasized in this regard that the tax benefits which the treaty would provide would not reduce Sea-Land's U.S. Federal income tax liability. Sea-Land Service, Inc., as a U.S. corporation, pays U.S. Federal income tax on its worldwide income, including the income derived from its Philippines shipping activities.

Ratification of this treaty would act to eliminate the current double taxation of Sea-Land's Philippines-sourced income. Ultimately, this burden of double taxation is borne, in part, by the U.S. Government in the form of tax credits against U.S. Federal income taxes for Philippines income taxes paid by U.S. companies doing business in the Philippines.

We are aware that the proposed United States-Philippines Income Tax Treaty does not contain an article with respect to the taxation of the air transport industry. It should be noted that the original draft of this treaty did specifically address the taxation of the air transport industry, and it was at the express request of that industry in 1976 that the present draft of the treaty before your committee deleted specific coverage of that industry.

Certainly, it would be inappropriate for the ratification process of this treaty to be further delayed at the expense of many U.S. taxpayers in order that the treaty might once again be extended to an industry which some 5 years ago voluntarily removed itself from specific treaty coverage.

With respect to the concerns expressed by some U.S. taxpayers that this treaty does not provide sufficient Philippines income tax concessions to warrant ratification, it is important to note in this regard that the proposed treaty would provide U.S. taxpayers with substantially the same income tax concessions accorded by the

Philippines to other of its major trading partners in recent tax treaties.

Viewed in this context and in light of the tax benefits which the proposed treaty would provide to the many U.S. taxpayers doing business in the Philippines, we at Sea-Land believe that this treaty should receive your committee's support. And we respectfully urge its prompt ratification.

Thank you for this opportunity to testify in favor of the ratification of the treaty.

Mr. TIPSON. Thank you, Mr. Finnerty.

ISSUES OF CONCERN RAISED BY AIRLINES

Would you comment directly on the suggestion that these treaties be approved with a reservation on the issues of concern raised by the airline?

Mr. FINNERTY. I think, as was indicated earlier by the Treasury witness, a Senate reservation with respect to the transportation provision because of the airline problem, would probably be fatal to the provision being available to the shipping interests.

As I have expressed in my testimony, we have already suffered a 5-year period of time, to the present, of sustaining double taxation of our earnings.

We would hope that the preferable solution of the problem would be to permit ratification of the treaty to take place and to solve the airline problem through a protocol to be negotiated between the governments, which I believe Treasury indicated it intends to pursue very promptly.

Mr. TIPSON. Mr. Hawkins, is it your expectation that if the Senate did attach a reservation to the treaty on the three points that you have raised, the Philippines would probably come around to accepting it, or that you would be satisfied with the results if there were no tax treaty at all? In other words, is it likely that we would get anything going that route, or is that simply a way of rejecting the treaty?

Mr. HAWKINS. We were told by Treasury, and in fact Treasury testified in 1977 before this committee, that the 1.5-percent gross receipts tax was available to the airlines and that they could get it.

In our discussions with international tax counsel over the last 4 years about how to cure the discrimination problems that exist—and I want to underscore that—we have a law in the United States about tax discrimination on airlines. We are a unique industry in that we operate parallel to a competing airline of the other action.

In the case of the Philippines airline, the only tax that it pays is an income tax either measured as 1.5 percent of gross receipts or a percentage of net income, if any. They do not pay any of the other taxes to which we are subjected. We are, in essence, charging the same fares, we are operating the same service, we fly many times the same type of airplanes.

That discrimination is something we need to have cured. From my reading of the treaty provisions, if airlines were included as shipping is included, I do not read that treaty as providing us protection from the discrimination in these other taxes. That is an issue that I think needs to be joined with the Philippine Government.

Second, we have been told in direct conversations with the internal revenue bureau of the Philippines that irrespective of the wording that is contained in article 5 on permanent business establishment, an airline which does not serve the Philippines but has a general sales agent—and let us make the record clear—general sales agent is a person of Philippine citizenship who represents that airline amongst other businesses that he does; he is not an employee of the airline—well, that constitutes under their interpretation a permanent business establishment. And they want to collect 1.5 or 2.5 percent of the revenue earned by that airline on a ticket sold in the Philippines.

A ticket is sold by an airline, Philippine Airlines, for instance, in the Philippines, from Manila to San Francisco and then on from San Francisco to New York. The leg San Francisco-New York is carried by a U.S.-flag airline.

Mr. **Tispon**. Does that practice apply to all foreign carriers? In other words, do the Japanese have the same problem?

Mr. **Hawkins**. I do not know about the Japanese. But JAL may be doing the carrying there, and JAL does have a business presence in the Philippines. So I am talking here of an airline flying that passenger from San Francisco to New York who does not have a business presence other than through a GSA. According to the internal revenue service of the Philippines, they should pay tax on that revenue. We find that unacceptable.

Mr. **Tipson**. Would you respond to the argument that I have heard made that the airlines could have had the deal they are looking for now 4 years ago?

Mr. **Hawkins**. We could have had the 1.5 percent 4 or 5 years ago when the treaty was negotiated, yes.

Mr. **Tipson**. But we have failed for 4 years to have the benefits of the treaty.

Mr. **Hawkins**. We still would not have had the cure on discrimination nor on the GSA issue, which I consider to be very important issues.

Mr. **Tipson**. Mr. Finnerty, would you like to comment on any of those points?

Mr. **Finnerty**. I think the only thing that might be added to the discussion is clearly there is a difference of opinion as to whether the entire treaty's ratification should be held up pending the resolution of these two or so points that have been mentioned. I think it is important to keep in mind whether the ratification of the treaty is the only potential channel which the airlines could pursue in seeking to resolve this problem.

Mr. **Tipson**. Thank you very much, gentlemen.

Senator **Mathias**. Gentlemen, I will read your colloquy in the transcript with great interest. I regret that I was not here and able to hear you in person. We were treated to a thrilling episode on the floor of an amendment which hung in suspense at a vote of 48-48, and nobody dared leave. But it was finally resolved.

We thank you for being here. And we will study your testimony with great interest. Thank you very much.

Mr. **Finnerty**. Thank you, Mr. Chairman.

Mr. **Hawkins**. Thank you, Mr. Chairman.

Senator **Mathias**. The next witness is Hon. Ron de Lugo, Delegate to Congress from the Virgin Islands.

I would ask if the Resident Commissioner of Puerto Rico is also here?

[Pause.]

Senator **Mathias**. I am told that he is on his way. We will ask him to join Mr. de Lugo when he arrives.

Mr. de Lugo, it is a particular pleasure for this committee to welcome you as a colleague as well as a spokeman for the Virgin Islands.

STATEMENT OF HON. RON DE LUGO, DELEGATE TO THE U.S. CONGRESS FROM THE VIRGIN ISLANDS

Delegate **de Lugo**. Thank you very much, Senator Mathias, for the opportunity to appear before your committee to testify on a matter of extreme importance to the U.S. Virgin Islands.

It should come as no surprise to this committee that my greatest concern regarding the proposed income tax treaty with the Nation of Jamaica centers around the provision that would permit U.S. taxpayers to take a tax deduction for expenses incurred while attending a business convention in that country.

The cause of my concern should be quite obvious. Since the passage of the Tax Reform Act back in 1976, when similar tax treatment was extended to the U.S. Virgin Islands, the convention business has become a significant component of our important tourist industry. In 1980, for example, convention visitor expenditures were estimated to be $6 million and over $600,000 in taxes was generated for our local treasury.

These are very modest figures, I realize, when we talk about billions of dollars up here these days. But they are significant figures for a small island community like the Virgin Islands. Since then, to accommodate for projected increases in convention traffic our hotels and resorts have begun expensive expansion projects, and the airports are being enlarged to accommodate bigger commercial airlines.

In addition, our public and private sectors have initiated an extensive campaign to promote further the Virgin Islands as a convention destination.

Extending the tax deduction to conventions held in Jamaica, however, undoubtedly will divert some of our anticipated convention business to our neighbor in the Caribbean and will also negate the preparations we have undertaken to accommodate or attract additional convention business.

On June 17, when I first learned of the administration's intention to extend the tax deduction to Jamaica, I along with several of my colleagues in the House on the Congressional Tourism Caucus wrote to the Secretary of the Treasury asking him to examine this issue very closely and to consider the impact that it would have on the tourism industries in the U.S. territories.

On July 23 I received a reply from Norman B. Ture, the Under Secretary of the Treasury for Tax and Economic Affairs. In his letter confirming that the administration intended to extend the tax deduction to Jamaica, he stated, and I quote, "I recognize the potential problems which this course of action may cause with respect to the issue which you raise."

Now, although I was pleased to see that the administration had gone on record as recognizing that problems will be created for us by this particular matter, I was concerned by the fact that no alternative or remedial action was put forward. As you know, the Constitution of the United States vests in the Congress plenary authority for the territories. In formulating policy, Congress must give appropriate attention to the economic, political, and social conditions of the offshore areas and, at the same time, see to it that our domestic policy is coordinated with our foreign policy in these regions.

Over the years, Congress has acted on this in developing certain specific programs and policies for our territories. These programs included, for example, convention tax deductions, rum tariff reductions, and special customs treatment. They were not developed overnight by the Congress. Instead, they were the result of years of study and experience in fulfiling its constitutional responsibilities to the United States territories.

Mr. Chairman, the message that I would like to convey to this committee is simple: I and the people of the U.S. Virgin Islands support this administration's efforts to assist our fellow West Indians on the island of Jamaica. However, we feel that there are alternative means of economic assistance other than extension of the convention tax benefit that will help that country get on its economic feet without upsetting the delicate economic advantage that Congress has sought over the years for the territories.

There is no question that extending the convention tax benefit to Jamaica will seriously impact our tourism economy and jeopardize the enormous investment that our local government and the Federal Government has made in enlarging our tourism-related facilities.

Mr. Chairman, also I would like to say that just before I took the witness stand I read in detail the statement that will be made by my colleague and neighbor in the Caribbean, the Resident Commissioner from Puerto Rico, Baltasar Corrada. I agree wholeheartedly with his statement.

Also, I would like to bring to the committee's attention a letter that was written by the chairman of the Energy Committee here in the Senate, James A. McClure, to the President of the United States just a few days ago commending the President for the Caribbean policy that this administration will undertake, but stating—and I will quote Chairman McClure; as you know, his committee has jurisdiction over the U.S. territories and is a counterpart to the committee on which I serve in the House, the Interior Committee.

Chairman McClure states to the President, "I am hopeful that, in formulating our policies, appropriate attention will be given to the role which the U.S. offshore areas can play and to the effect of our policies on these areas." And then I will further quote him. He says, "I think that it is crucial that the economic, political, and social conditions in our offshore areas and the coordination of our domestic policy toward these areas with our foreign policy in the region be undertaken."

And also in the letter to the Secretary of State, Secretary Haig, Chairman McClure wrote on September 17, "I hope that you will continue to keep me advised during the formulation of these policies and will actively involve representatives from the insular governments."

And a similar letter was sent to the Secretary of the Interior, James Watt, stating that, "A comprehensive foreign policy for the Caribbean and the Pacific basins will necessarily impact on U.S. territories. And I have recommended that the administration consider a domestic component to these policies.

Senator Mathias, my concern here is not just the convention tax benefit, however. What concerns me is that other programs and economic advantages that Congress has so carefully developed for the U.S. territories will be similarly negated by quick and possibly rash decisions in foreign policy that fail to take into account the impact on domestic policy and specifically territorial policy that is the constitutional responsibility of the Congress.

The Caribbean basin must be seen as a whole. And the territory of the Virgin Islands must be recognized as a American presence there, the vanguard, if you will, in that area. The granting of one tax benefit to one small country might appear on the surface to be a minor matter, a small gesture of support to a troubled country trying to fight its way back.

In the interest of that country, Jamaica, and the interest of the American citizens and the residents of the U.S. Virgin Islands, I ask that this entire matter be viewed in its full perspective and that there are many, many ways to aid Jamaica. There must be a way to do so without jeopardizing the economic well-being of the United States territories for which Congress holds the ultimate responsibility.

AMERICAN PRESENCE IN CARIBBEAN

Senator **Mathias**. We value your view on this very much. Of course, there is a deep concern in the Congress for the welfare of both Puerto Rico and the Virgin Islands. And as you have said, it is an American presence in the Caribbean.

That American presence confers great benefits on the mainland. It also imposes great responsibilities on the mainland. And when you consider the comparative size of the mainland economy with the economies of either Puerto Rico or the Virgin Islands, that enhances the responsibility, because if Prime Minister Trudeau can say that "To live north of the Canadian border is sleeping next to an elephant," that metaphor would have to be substantially enlarged in order to properly recognize the comparative positions of the mainland, the continental United States, and these two important island outposts.

So we take what you say with great seriousness.

Delegate **de Lugo**. Thank you very much, Mr. Chairman.

COMMITMENT MADE TO JAMAICA

Mr. Chairman, let me say that the real purpose of my being here today is this: I realize that a commitment has been made to Jamaica. I support that. I realize that we view it as in our national interest, and we the people of the Virgin Islands support that. My real purpose in appearing here today was primarily to bring to the attention of this committee and to the administration the fact that we are going to have to look at the impact on the territories of the good gestures that we make toward our allies.

I am sure that we are going to be helping the other island nations in the Caribbean. As you point out, our economy in relation to the mainland, while Munoz Marin, the former Governor of Puerto Rico, said sometime ago, "When the United States sneezes, Puerto Rico catches pneumonia," well, we catch a cold in the Virgin Islands at the same time.

Senator MATHIAS. I think you have very ably represented that position. I think your words have been heard here in the committee.

When you said earlier that we have to consider the Caribbean as a whole, that, of course, is a proposition that cuts both ways. We have to consider our relations with the island republics such as Jamaica and consider their problems as well, as the largest continental neighbor that they have, but I would not want you or your constituents to be in any doubt as to the very strong feeling that we have about the welfare of the Virgin Islands and of Puerto Rico. Those are interests that you have very ably represented here today.

Delegate DE LUGO. Thank you very much, Mr. Chairman, for this opportunity.

Senator MATHIAS. Mr. Corrada, if you will come to the table, I cannot say that your work is done, but your way has been prepared by the distinguished delegate from the Virgin Islands. Since we were not sure that you were going to get here before we adjourned, we already have put your statement into the record. So if you would like to add a few words, we would be happy to hear from you.

I have expressed on behalf of the committee our great interest in and concern for the welfare for the Commonwealth of Puerto Rico. It is one of the most favorite spots on the face of the globe. We recognize its importance to the United States as well as the responsibilities of the United States to the Commonwealth.

STATEMENT OF HON. BALTASAR CORRADA, RESIDENT COMMISSIONER OF PUERTO RICO

Commissioner CORRADA. Mr. Chairman, I appreciate that. Of course, I want to express my appreciation for your placing my entire testimony in the record of these hearings. Since you have done so, I will not read it at this time.

I would just like to emphasize, as did my colleague in the House, the Delegate from the Virgin Islands, Ron de Lugo, that we are now facing a very difficult situation. The impact of all of the budget cutbacks in different Federal programs in Puerto Rico we estimate will exceed $450 million.

The reduction of significant Federal programs in Puerto Rico that affect the social development of the Island coupled with policies like this one which will result in further deterioration of industry there and the private sector, such as the tourism industry, would be creating the kind of condition that will result in deteriorating the economic development of Puerto Rico as well as the Virgin Islands.

I urge the committee to seriously examine this situation and to pursue other lines of support to the people and the Government of Jamaica that are not inconsistent with the development of the U.S. domestic areas in the Caribbean. I know that there are many ways that we can help Jamaica, and I fully support the efforts of this committee, Congress, and President Reagan in supporting the government there and the people of Jamaica.

That is not the question here. The question is why should we do it by supporting policies that at the same time will deteriorate the economies of the U.S. domestic areas in the Caribbean. Therefore, this matter has to be carefully analyzed. We urge the committee to do so and to hold off the ratification of the protocol until a serious study is conducted of the impact this may have in the Puerto Rican and the Virgin Islands economy.

[Mr. Corrada's prepared statement follows:]

PREPARED STATEMENT OF HON. BALTASAR CORRADA

Mr. Chairman, Members of the Committee, I am appearing before you this afternoon to express my deep concern with Article IV of Treaty Document 97-17, the proposed Protocol amending the 1980 Tax Convention with Jamaica. Article IV adds a new provision to Article 25 of the Convention to permit United States citizens to deduct expenses incurred while attending business conventions in Jamaica.

The Protocol was negotiated as a result of Prime Minister Edward Seaga's visit to Washington in January during which certain commitments were made by President Reagan to provide assistance to Jamaica. While I am the first to praise and encourage our country's willingness to assist Jamaica, we must not ignore the impact of these decisions on other jurisdictions of the United States. No assessment or evaluation was made of the effects of Article IV of the Protocol on the domestic insular areas of the Caribbean and the Pacific. At a time when we are all feeling the effects of the budget cutbacks mandated by the Budget Reconciliation Act, we must avoid policy decisions that will affect our ability to create jobs and provide work for our citizens. The President's call for a reduction in Federal spending and programs is coupled with an exhortation to the States to take over more of the responsibility of providing for its own residents.

In Puerto Rico, Mr. Chairman, we have always tried to do that. However, we face a situation where Puerto Rico will suffer a reduction of more than $450 million in Federal expenditures for fiscal year 1982 when compared to amounts anticipated before the budget cutbacks. If you add to this the fact that a key to our economic life—tourism—will suffer an adverse impact that will limit our ability to create new jobs if this Protocol is ratified, you must realize that we are being buffeted from all sides.

Mr. Chairman, Prime Minister Seaga ought to be commended for his effective leadership and his attempts to bring his country back into a firmer economic standing. However, economic and other types of assistance to Jamaica should be provided through bilateral agreements and multilateral financial programs that may help to strengthen the Jamaican economy without weakening the economic position of Puerto Rico and the U.S. Virgin Islands.

The cumulative impact of this and other grantings of tax deductions for business conventions in foreign countries on Puerto Rico, the U.S. Virgin Islands and other insular areas would be significant.

Mr. Chairman, the tourism industry is a vital element of the development of our economy. There was a threefold increase in the number of tourists during the decade of the 1960's from 347,425 tourists spending a total of $58.1 million in 1959-60 to a total of 1,088,379 tourists spending a total of $235.4 million during 1969-70. The level of growth had been maintained so that in fiscal year 1979-80 a total of 2,180,374 tourists spent $615.4 million while visiting Puerto Rico. However, preliminary data for fiscal year 1980-81 shows a decline in tourists to a figure of 1,996,231 who spent a total of $602.8 million. These figures are of great concern to us and should cause the Reagan Administration to take a second look to policies that would have a deleterious effect on the continued growth of tourism in Puerto Rico.

An indispensable ingredient to the development of our tourism to its maximum potential is our ability to attract business groups and conventions to Puerto Rico. The number of groups and conventions that traveled to Puerto Rico increased by 7.5 percent between fiscal year 1979-80 and fiscal year 1980-81, from a total of 855 conventions and 82,639 visitors in 1979-80 to 1,298 conventions and 88,815 visitors in 1980-81. These numbers represent 16.8 percent of the total number of hotel visitors in Puerto Rico for 1980-81, a significant number. The Government of Puerto Rico is actively seeking to attract more business conventions as part of our overall efforts to increase tourism to the Island.

The Reagan Administration's plan to develop a policy for assistance to the Caribbean Basin is not only welcomed by us in Puerto Rico, but we also anticipate being an active partner in the development and implementation of this policy as a means of promoting greater understanding between our Nation and our neighbors in the Caribbean. The Administration needs to identify the specific areas to be addressed in its plan and should undertake a comprehensive examination of its different elements, including the impact of options under consideration, on the economies of Puerto Rico and the U.S. Virgin Islands before any plan is actually implemented. I urge the Administration to do that before any further bilateral negotiations are conducted with other countries in the Caribbean to avoid the situation we are facing today with this Protocol. I also urge the Administration in the future, to consult with us and others who may be affected by actions and decisions of this kind. I appreciate the need for providing aid to countries whose governments are friendly to our own, but we must keep in mind that we do not, in the process, hurt our own people by chipping away at their ability to attract business and generate jobs. For in the final analysis, in our efforts to help others, we must not do so at the expense of our own people and our own economic stability.

I welcome initiatives and proposals from the Administration to stimulate economic growth and job creation in the insular areas to counter the effects of the loss of business from their efforts to help foreign countries. In this manner, we can guarantee a lessening of the impact of these actions on each of our areas while carrying on the Nation's interests.

Thank you and I appreciate the opportunity to appear before you this afternoon.

Senator MATHIAS. Thank you very much, Mr. Corrrada. I think I can assure you that the committee in its consideration of the treaties will study your statement very carefully and take your position into consideration.

Thank you very much for being here.

Commissioner CORRADA. Thank you very much, Mr. Chairman.

Senator MATHIAS. Mr. Samuel Hayden, President of the Council of the Americas, was scheduled to appear before our committee today to offer testimony. However, his plane was delayed, and he did not arrive. We will ask that his prepared testimony be placed into the record at this point.

[Mr. Hayden's prepared statement follows:]

PREPARED STATEMENT OF SAMUEL L. HAYDEN, PRESIDENT, COUNCIL OF THE AMERICAS

Mr. Chairman, my name is Samuel Hayden and I am president of the Council of the Americas, a business association of more than 200 U.S. corporations. The council works actively to promote private enterprise as a positive force in the development of the Caribbean and Latin America. My organization also serves as the institutional base of the U.S. Business on Jamaica, chaired by David Rockefeller. I serve as treasurer of that committee.

Mr. Chairman, I appreciate the opportunity to testify before this committee on such an important issue as Jamaican development. The council recognizes the important role tax treaties play in the process of economic development. Currently, the Council of the Americas has organized a committee of tax specialists from member corporations to explore the economic and political feasibility of specific foreign and domestic tax reforms. Upon completion of our committee's work, we would be pleased to share our conclusions with you.

As we all are aware, in November of 1980, the Jamaican people elected a new Government dedicated to the principles of private enterprise, individual liberty, and free market economics. This shift in ideology was unanimously welcomed from all sectors of the United States. To further demonstrate American support for this new Government, only 9 months ago, on January 27, President Reagan and Prime Minister Seaga stood on the balcony of the White House and pledged to make Jamaica the "showcase of democracy in the Caribbean." But, progress toward Jamaican development has been stalled by a long negotiation process. We anticipate that the executive branch will come forth with a most comprehensive, progressive package for Jamaica. But in the meantime, indeed today, Congress has the opportunity to assert itself in the foreign policy arena and take the first constructive action toward furthering the development of Jamaica. This first constructive action would be the ratification of the Jamaica tax protocol which extends convention tax exemption—that is, North American treatment—to Jamaica.

The Council of the Americas urges passage of this measure for five significant reasons:

1. It is a self-help rather than a "give-away" program. This measure gives the Jamaicans the opportunity to help themselves. By passing this measure, the United States simply provides an opportunity. In order for this measure to have an affect, the Jamaican Government will be provided with an incentive to increase the stock and quality of their tourist facilities. Jamaica realizes this; they realize that they need to act quickly if they are to revive their sagging tourist industry, which is so vitally important to the economy. By passing this treaty, the United States provides Prime Minister Seaga with a means to earn badly needed foreign exchange, rather than being forced to borrow.

2. Extending convention tax exemption to Jamaica will have a negligible effect on the revenues of the U.S. Treasury. While specific figures are not available, it is doubtful that U.S. tax revenues would be negatively affected. The reasoning behind this is that deductible business conventions are presently taking place in the United States. If we extend this tax exemption to Jamaica, the location of the exemption may change, but the aggregate sum deducted from U.S. tax revenues will remain constant, and will not significantly be depleted.

3. This exemption can be passed without affecting the tourism industry of Puerto Rico and the Virgin Islands. The type of convention that is held in Jamaica is totally different from the type that is held in Puerto Rico and the Virgin Islands. Puerto Rico and the Virgin Islands have large convention center facilities that can accommodate hundreds of people. Jamaican facilities have a maximum of about 150 to 200 people. By passing this exemption, conventions will not leave Puerto Rico and the Virgin Islands and go to Jamaica. There simply are not the facilities to accommodate a large group, and the situation of the Jamaican economy precludes the building of larger facilities. This exemption allows Jamaica to host small business meetings, which would not be a threat to anyone else's tourist industry.

4. Inasmuch as these negotiations have been conducted within the framework of a treaty, the United States is receiving concessions as well. The protocol contains a strong antitreaty "shopping provision"—in fact, the strongest found in any U.S. income tax treaty, according to the Joint Committee on Taxation. Under this provision, treaty benefits would not be extended to non-Jamaican residents who set up Jamaican companies solely for the purpose of taking advantage of those benefits. The protocol also contains a commitment from Jamaica to negotiate a mutual assistance treaty. Finally, the Jamaican Government has agreed to "open its books" to the U.S. Government in order to insure that the United States has complete access to all the information needed to monitor the economics of the agreement. This is a significant concession on their part. Many other Caribbean countries have expressed interest in negotiating similar treaties, but only Jamaica has been willing to guarantee U.S. access to government records.

5. Passage of this treaty would send a positive message to the Caribbean. The U.S. Congress has an excellent opportunity to demonstrate its concern for furthering the development of the Caribbean. Passage would also send a signal of support to the Jamaican people, and to others who are considering a shift of emphasis toward private sector economics.

Having experienced eight continuing years of declining growth during past administrations, Jamaica under Prime Minister Seaga is faced with the exigencies of economic reconstruction. The political commitment to democracy and a market economy has been made by the Jamaican people. The shift has been made in a direction consistent with U.S. foreign policy interests. The value of the tax convention granting North American treatment to Jamaica is that this legislation will encourage private sector-to-private sector contacts in an industry in which Jamaica has some comparative economic advantage. While official U.S. assistance is undoubtably important, passage of this tax convention should provide an incentive for the Jamaican tourism industry to rejuvenate itself. Most important, passage would express to the Jamaican people our concern and willingness to see development take place through open market practices.

Senator MATHIAS. The committee will stand adjourned subject to the call of the Chair.

[Additional questions and answers follow:]

DEPARTMENT OF THE TREASURY'S RESPONSE TO AN ADDITIONAL QUESTION SUBMITTED BY SENATOR PRESSLER

Question. Suppose that several years ago, a Canadian resident created a U.S. corporation in which he invested $100, and that the corporation in turn invested the $100 in U.S. real property. The fair market value of the real property (and of the stock of the corporation) is now $250, and let us assume that $250 continues to be the value at all relevant times.

If the Canadian resident were to realize his $150 gain now, the gain would be exempt under the existing treaty. This woud be true whether he sold his stock, or first liquidated the corporation and then sold the real property.

I understand that paragraph 9 of Article XIII is intended to preserve an exemption for the $150 appreciation in value that would have been available under the existing treaty. This seems to be the result if the Canadian resident were to sell the stock of the corporation. Since substance should prevail over form, I assume that this would also be true if the Canadian resident were first to liquidate the corporation, and then sell the real property. Is this correct?

Answer. Paragraph 9 of Article XIII of the proposed Convention was designed as a transitional rule from the existing income tax convention between the United States and Canada ("Existing Convention"). Under the Existing Convention, gains derived by a Canadian resident or entity from the sale of capital assets are generally exempt from U.S. tax. However, gains derived from such sales by a U.S. corporation owned by a Canadian resident are subject to tax. This latter rule represents our basic policy not to relinquish a taxing right on the income of U.S. taxpayers by treaty.

Thus, the transitional rule in the proposed Convention was limited, for U.S. tax purposes, to cases where a Canadian resident alienates property which was owned by a Canadian resident on the date of signature of the proposed Convention, and which did not form part of the business property of a permanent establishment or pertain to a fixed base in the United States. If the property was owned by a U.S. resident, a sale by that U.S. resident would have been subject to U.S. tax. Accordingly, in the example you have raised, the Canadian resident would be unable to apply the transitional rule of paragraph 9 of Article XIII of the proposed Convention if he were to sell the real property received upon the liquidation of the corporation. The transitional rule would, however, apply to any gain recognized by the Canadian resident for U.S. tax purposes upon the liquidation of the U.S. company, assuming the other conditions of paragraph 9 of Article XIII were satisfied.

However, the Canadian individual's U.S. tax liability on a later sale of the real property could be reduced if he were to receive a "step-up" in basis in the real property upon liquidation. Normally, under the Internal Revenue Code, an individual shareholder will take as his basis in property received upon liquidation the fair market value of the property at the time of liquidation. In your example, if this rule were to apply, the Canadian individual would have a $250 basis in the real property. However, in section 1125(d) of the Foreign Investment in Real Property Tax Act, Public Law 96-499, a provision was inserted which states that if a U.S. real property interest is disposed of to a related party, the basis of the interest to the transferee is reduced by the amount of any "nontaxed gain." For this purpose, "nontaxed gain" is defined as any gain not subject to tax because of any U.S. treaty obligation. The issue which arises in your example is whether, under this statutory provision, the Canadian individual would be required to reduce his basis by the amount of gain not taxed to him upon liquidation by reason of the exemption in the Existing Convention or the transitional rule in the proposed Convention, or whether the term "nontaxed gain" refers only to gain not taxed to the transferor because of a treaty obligation. The Treasury Department is reviewing this issue and hopes to resolve the ambiguity by regulations to be promulgated in the near future.

Department of the Treasury's Responses to Additional Questions Submitted by Senator Pell

Question 1. Assume that on September 26, 1980, a Canadian resident holds for investment land located in the United States. If the Canadian resident were to sell this land, paragraph 9 of Article XIII would exempt from tax any gain attributable to the period prior to December 31 of the year in which the treaty is ratified.

Suppose that instead of selling property A, the Canadian resident exchanged it for property B. Under section 1031, this would be a tax-free exchange, and the basis for property B would be the same as the basis was for property A. In effect, the gain on property A, which would have been exempt under paragraph 9 of Article XIII of the treaty, is deferred until property B is disposed of. If the Canadian resident should later dispose of property B, I assume he would still be exempt on the portion of his gain attributable to the period prior to December 31 of the year of ratification. Is this correct?

Answer. Paragraph 9 of Article XIII of the proposed Convention was designed as a transitional rule from the existing income tax convention with Canada. The rule in the proposed Convention was limited, for U.S. tax purposes, to cases where a Canadian resident alienates property which was owned by a Canadian resident on the date of signature of the proposed Convention, and which did not form part of the business property of a permanent establishment or pertain to a fixed base in the United States.

Accordingly, in your example, the Canadian resident would be entitled to claim the benefits of paragraph 9 of Article XIII of the proposed Convention if property B was owned by a resident of Canada on September 26, 1980 (the date of signature of the proposed Convention).

Question 2. Suppose that on September 26, 1980, a U.S. corporation owned land in the United States having a basis of $5, and that all of the stock of the corporation was owned by a Canadian resident who had a basis of $10 for such stock. The property has a value of $30.

If the corporation were to be liquidated under section 331, the Canadian resident would have a gain of $20 ($30, less the stock basis of $10). Under the existing treaty, this gain would be exempt. Also, under paragraph 9 of Article XIII of the proposed Treaty, such gain would be exempt to the extent attributable to the period prior to December 31, of the year of ratification. It would seem, therefore, that if the Canadian resident were to later sell the land he received on liquidation of the corporation, he could be subject to tax only to the extent of the post-December 31 value. Some confusion, however, seems to exist because of section 1125(d) of FIRPTA.

In general, section 1125(d) provides that where U.S. property is transferred to a related party, then the basis of such property in the hands of the transferee is to be reduced by the amount of nontaxed gain, i.e., gain exempt under a treaty. It would seem that the "nontaxed gain" referred to in section 1125(d) is the exempt gain, if any, of the transferor. In this case, the transferor would be the liquidating U.S. corporation which had no "nontaxed gain" and there would be no basis reduction to the shareholder.

(a) Is this a correct interpretation of section 1125(d)?

(b) If this is not a correct interpretation of section 1125(d), then no problem would arise if the Canadian resident were still entitled to the exemption under paragraph 9 of Article XIII of the proposed Treaty when he later sold the land. It would seem that this would be consistent with the policy of both section 1125(d) as well as the proposed Treaty. Would the Canadian resident be entitled to such exemption?

Answer. (a) Section 1125(d) of the Foreign Investment in Real Property Tax Act, Public law 96-499, defines the term "nontaxed gain" to include any gain not subject to tax because of any U.S. treaty obligation. As you stated, the issue which arises is whether, under this statutory provision, the Canadian individual would be required to reduce his basis by the amount of gain not taxed to him upon liquidation of the U.S. corporation by reason of the exemption in the existing United States-Canada Convention or the transitional rule in the proposed Convention, or whether "nontaxed gain" refers only to gain not taxed to the transferor because of a treaty obligation. (In your example, no treaty provision could exempt any gain of the transferor because it is a U.S. corporation). The Treasury Department is reviewing this issue and hopes to resolve the ambiguity by regulations to be promulgated in the near future.

(b) Paragraph 9 of Article XIII of the proposed Convention was designed as a transitional rule from the existing Convention. Under the existing Convention, gains derived by a Canadian resident or entity from the sale of capital assets are generally exempt from U.S. tax. However, gains derived from such sales by a U.S. corporation owned by a Canadian resident are subject to U.S. tax.

Thus, the transitional rule in the proposed Convention was limited, for U.S. tax purposes, to cases where a Canadian resident alienates property which was owned by a Canadian resident on the date of signature of the proposed Convention, and which did not form part of the business property of a permanent establishment or pertain to a fixed base in the United States. If the property was owned by a U.S. resident, a sale by that U.S. resident would have been subject to U.S. tax. In your example, the Canadian resident would be unable to apply the transitional rule of paragraph 9 of Article XIII of the proposed Convention if he were to sell the land received on liquidation of the corporation. The transitional rule would, however, apply to any gain recognized by the Canadian resident for U.S. tax purposes upon the liquidation of the U.S. corporations, assuming the other conditions of paragraph 9 of Article XIII were satisfied.

[Whereupon, at 3:58 p.m., the committee adjourned, subject to call of the Chair.]

APPENDIX I: TECHNICAL EXPLANATIONS

TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND CANADA WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL SIGNED AT WASHINGTON, D.C. ON SEPTEMBER 26, 1980

INTRODUCTION

In this technical explanation of the Convention between the United States and Canada signed on September 26, 1980 ("the Convention"), references are made to the Convention and Protocol between Canada and the United States with respect to Income Taxes signed on March 4, 1942, as amended by the Convention signed on June 12, 1950, the Convention signed on August 8, 1956 and the Supplementary Convention signed on October 25, 1966 (the "1942 Convention"). These references are intended to put various provisions of the Convention into context. The technical explanation does not, however, provide a complete comparison between the Convention and the 1942 Convention. Moreover, neither the Convention nor the technical explanation is intended to have implications for the interpretation of the 1942 Convention.

The technical explanation is an official guide to the Convention. It reflects policies behind particular Convention provisions, as well as understandings reached with respect to the interpretation and application of the Convention.

Article I. PERSONAL SCOPE

Article I provides that the Convention is generally applicable to persons who are residents of either Canada or the United States or both Canada and the United States. The word "generally" is used because certain provisions of the Convention apply to persons who are residents of neither Canada nor the United States.

Article II. TAXES COVERED

Paragraph 1 states that the Convention applies to taxes "on income and on capital" imposed on behalf of Canada and the United States, irrespective of the manner in which such taxes are levied. As of September 26, 1980 neither Canada nor the United States imposed taxes on capital. Paragraph 1 is not intended either to broaden or to limit paragraph 2, which provides that the Convention shall apply, in the case of Canada, to the taxes imposed by the Government of Canada under Parts I, XIII, and XIV of the Income Tax Act and, in the case of the United States, to the Federal income taxes imposed by the Internal Revenue Code ("the Code").

National taxes not generally covered by the Convention include, in the case of the United States, the estate, gift, and generation-skipping transfer taxes, the Windfall Profits Tax, Federal unemployment taxes, social security taxes imposed under sections 1401, 3101, and 3111 of the Code, and the excise tax on insurance premiums imposed under Code section 4371. The Convention also does not generally cover the Canadian excise tax on net insurance premiums paid by residents of Canada for coverage of a risk situated in Canada. However, the Convention has the effect of covering the Canadian social security tax in certain respects because under Canadian domestic tax law no such tax is due if there is no income subject to tax under the Income Tax Act of Canada. Taxes imposed by the states of the United States, and by the provinces of Canada, are not generally covered by the Convention. However, if such taxes are imposed in accordance with the provisions of the Convention, a foreign tax credit is ensured by paragraph 7 of Article XXIV (Elimination of Double Taxation).

Paragraph 2 contrasts with paragraph 1 of the Protocol to the 1942 Convention, which refers to "Dominion income taxes." In addition, unlike the 1942 Convention, the Convention does not contain a reference to "surtaxes and excess-profits taxes."

Paragraph 3 provides that the Convention also applies to any taxes identical or substantially similar to the taxes on income in existence on September 26, 1980 which are imposed in addition to or in place of the taxes existing on that date. Similarly, taxes on capital imposed after that date are to be covered.

It was agreed that Part I of the Income Tax Act of Canada would meet the requirements of paragraph 3(a) if Canada were to enact a low flat rate tax on resource revenues which would not be deductible in computing income under Part I. This agreement is not intended to have implications for any other convention or for the interpretation of Code sections 901 and 903. Further, the flat rate tax would not be a tax described in paragraphs 2 or 3. After Canada proposed enactment of an eight percent tax on oil and gas production revenues, it was confirmed that this tax was consistent with the understanding reached during the negotiations.

Paragraph 4 provides that, notwithstanding paragraphs 2 and 3, the Convention applies to certain United States taxes for certain specified purposes: the accumulated earnings tax and personal holding company tax are covered only to the extent necessary to implement the provisions of paragraphs 5 and 8 of Article X (Dividends); the excise taxes imposed with respect to private foundations are covered only to the extent necessary to implement the provisions of paragraph 4 of Article XXI (Exempt Organizations); and the social security taxes imposed under sections 1401, 3101, and 3111 of the Code are covered only to the extent necessary to implement the provisions of paragraph 4 of Article XXIX (Miscellaneous Rules). The pertinent provisions of Articles X, XXI, and XXIX are described below. Canada has no national taxes similar to the United States accumulated earnings tax, personal holding company tax, or excise taxes imposed with respect to private foundations.

Article II does not specifically refer to interest, fines and penalties. Thus, each Contracting State may, in general, impose interest, fines, and penalties or pay interest pursuant to its domestic laws. Any question whether such items are being imposed or paid in connection with covered taxes in a manner consistent with provisions of the Convention, such as Article XXV (Non-Discrimination), may, however, be resolved by the competent authorities pursuant to Article XXVI (Mutual Agreement Procedure). See, however, the discussion below of the treatment of certain interest under Articles XXIX (Miscellaneous Rules) and XXX (Entry Into Force).

Article III. GENERAL DEFINITIONS

Article III provides definitions and general rules of interpretation for the Convention. Paragraph 1(a) states that the term "Canada," when used in a geographical sense, means the territory of Canada, including any area beyond the territorial seas of Canada which, under international law and the laws of Canada, is an area within which Canada may exercise rights with respect to the seabed and subsoil and their natural resources. This definition differs only in form from the definition of Canada in the 1942 Convention; paragraph 1(a) omits the reference in the 1942 Convention to "the Provinces, the Territories and Sable Island" as unnecessary.

Paragraph 1(b)(i) defines the term "United States" to mean the United States of America. The term does not include Puerto Rico, the Virgin Islands, Guam, or any other United States possession or territory.

Paragraph 1(b)(ii) states that when the term "United States" is used in a geographical sense the term also includes any area beyond the territorial seas of the United States which, under international law and the laws of the United States, is an area within which the United States may exercise rights with respect to the seabed and subsoil and their natural resources.

Paragraph 1(c) defines the term "Canadian tax" to mean the taxes imposed by the Government of Canada under Parts I, XIII, and XIV of the Income Tax Act as in existence on September 26, 1980 and any identical or substantially similar taxes on income imposed by the Government of Canada after that date and which are in addition to or in place of the then existing taxes. The term does not extend to capital taxes, if and when such taxes are ever imposed by Canada.

Paragraph 1(d) defines the term "United States tax" to mean the Federal income taxes imposed by the Internal Revenue Code as in existence on September 26, 1980 and any identical or substantially similar taxes on income imposed by the United States after that date in addition to or in place of the then existing taxes. The term does not extend to capital taxes, nor to the United States taxes identified in paragraph 4 of Article II (Taxes Covered).

Paragraph 1(e) provides that the term "person" includes an individual, an estate, a trust, a company, and any other body of persons. Although both the United States and Canada do not regard partnerships as taxable entities, the definition in the paragraph is broad enough to include partnerships where necessary.

Paragraph 1(f) defines the term "company" to mean any body corporate or any entity which is treated as a body corporate for tax purposes.

The term "competent authority" is defined in paragraph 1(g) to mean, in the case of Canada, the Minister of National Revenue or his authorized representative and, in the case of the United States, the Secretary of the Treasury or his delegate. The Secretary of the Treasury has delegated the general authority to act as competent authority to the Commissioner of the Internal Revenue Service, who has redelegated such authority to the Assistant Commissioner (Compliance) with the concurrence, in certain cases, of the Assistant Commissioner (Technical). The Assistant Commissioner (Compliance) has redelegated authority to the Director of International Operations to administer programs for routine and specific exchanges of information and mutual assistance in collection and to the Director, Examination Division, to administer programs for simultaneous and industrial exchanges of information.

Paragraph 1(h) defines the term "international traffic" to mean any voyage of a ship or aircraft to transport passengers or property, except where the principal purpose of the voyage is transport between points within a Contracting State. A voyage of a ship or aircraft that includes stops in both Contracting States may thus not be international traffic if the principal purpose of the voyage is to transport passengers or property within a Contracting State.

Paragraph 1(i) defines the term "State" to mean any national State, whether or not a Contracting State.

Paragraph 1(j) establishes "the 1942 Convention" as the term to be used throughout the Convention for referring to the pre-existing income tax treaty relationship between the United States and Canada.

Paragraph 2 provides that, in the case of a term not defined in the Convention, the domestic tax law of the Contracting State applying to the Convention shall control, unless the context in which the term is used requires a definition independent of domestic tax law or the competent authorities reach agreement on a meaning pursuant to Article XXVI (Mutual Agreement Procedure). The term "context" refers to the purpose and background of the provision in which the term appears.

Pursuant to the provisions of Article XXVI, the competent authorities of the Contracting States may resolve any difficulties or doubts as to the interpretation or application of the Convention. An agreement by the competent authorities with respect to the meaning of a term used in the Convention would supersede conflicting meanings in the domestic laws of the Contracting States.

Article IV. RESIDENCE

Article IV provides a detailed definition of the term "resident of a Contracting State." The definition begins with a person's liability to tax as a resident under the respective taxation laws of the Contracting States. A person who, under those laws, is a resident of one Contracting State and not the other need look no further. However, the Convention definition is also designed to assign residence to one State or the other for purposes of the Convention in circumstances where each of the Contracting States believes a person to be its resident. The Convention definition is, of course, exclusively for purposes of the Convention.

Paragraph 1 provides that the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature. The phrase "any other criterion of a similar nature" includes, for U.S. purposes, an election under the Code to be treated as a U.S. resident. An estate or trust is, however, considered to be a resident of a Contracting State only to the extent that income derived by such estate or trust is liable to tax in that State either in its hands or in the hands of its beneficiaries. To the extent that an estate or trust is considered a resident of a Contracting State under this provision, it can be a "beneficial owner" of items of income specified in other articles of the Convention - e.g., paragraph 2 of Article X (Dividends).

Paragraphs 2, 3, and 4 provide rules to determine a single residence for purposes of the Convention for persons resident in both Contracting States under the rules set forth in paragraph 1. Paragraph 2 deals with individuals. A "dual resident" individual is initially deemed to be a resident of the Contracting State in which he has a permanent home available to him. If the individual has a permanent home available to him in both States or in neither, he is deemed to be a resident of the Contracting State with which his personal and economic relations are closer. If the personal and economic relations of an individual are not closer to one Contracting State than to the other, the individual is deemed to be a resident of the Contracting State in which he has an habitual abode. If he has such an abode in both States or in neither State, he is deemed to be a resident of the Contracting State of which he is a citizen. If the individual is a citizen of both States or of neither, the competent authorities are to settle the status of the individual by mutual agreement.

Paragraph 3 provides that if, under the provisions of paragraph 1, a company is a resident of both Canada and the United States, then it shall be deemed to be a resident of the State under whose laws (including laws of political subdivisions) it was created. Paragraph 3 does not refer to the State in which a company is organized, thus making clear that the tie-breaker rule for a company is controlled by the State of the company's original creation. Various jurisdictions may allow local incorporation of an entity that is already organized and incorporated under the laws of another country. Paragraph 3 provides certainty in both the United States and Canada with respect to the treatment of such an entity for purposes of the Convention.

Paragraph 4 provides that where, by reason of the provisions of paragraph 1, an estate, trust, or other person, other than an individual or a company, is a resident of both Contracting States, the competent authorities of the States shall by mutual agreement endeavor to settle the question and determine the mode of application of the Convention to such person. This delegation of authority to the competent authorities complements the provisions of Article XXVI (Mutual Agreement Procedure), which implicitly grant such authority.

Paragraph 5 provides a special rule for certain government employees, their spouses, and dependent children. An individual is deemed to be a resident of a Contracting State if he is an employee of that State or of a political subdivision, local authority, or instrumentality of that State, is rendering services in the discharge of functions of a governmental nature in any State, and is subjected in the first-mentioned State to "similar obligations" in respect of taxes on income as are residents of the first-mentioned State. Paragraph 5 provides further that a spouse and dependent children residing with a government employee and also subject to "similar obligations" in respect of income taxes as residents of the first-mentioned State are also deemed to be residents of that State. Paragraph 5 overrides the normal tie-breaker rule of paragraph 2. A U.S. citizen or resident who is an employee of the U.S. government in a foreign country or who is a spouse or dependent of such employee is considered to be subject in the United States to "similar obligations" in respect of taxes on income as those imposed on residents of the United States, notwithstanding that such person may be entitled to the benefits allowed by sections 911 or 912 of the Code.

Article V. PERMANENT ESTABLISHMENT

Paragraph 1 provides that for the purposes of the Convention the term "permanent establishment" means a fixed place of business through which the business of a resident of a Contracting State is wholly or partly carried on. Article V does not use the term "enterprise of a Contracting State," which appears in the 1942 Convention. Thus, paragraph 1 avoids introducing an additional term into the Convention. The omission of the term is not intended to have any implications for the interpretation of the 1942 Convention.

Paragraph 2 provides that the term "permanent establishment" includes especially a place of management, a branch, an office, a factory, a workshop, and a mine, oil or gas well, quarry, or any other place of extraction of natural resources. Paragraph 3 adds that a building site or construction or installation project constitutes a permanent establishment if and only if it lasts for more than 12 months. Paragraph 4 provides that a permanent establishment exists in a Contracting State if the use of a drilling rig or drilling ship in that State to explore for or exploit natural resources lasts for more than 3 months in any 12 month period, but not if such activity exists for a lesser period of time.

Paragraph 5 provides that a person acting in a Contracting State on behalf of a resident of the other Contracting State is deemed to be a permanent establishment of the resident if such person has and habitually exercises in the first-mentioned State the authority to conclude contracts in the name of the resident. This rule does not apply to an agent of independent status, covered by paragraph 7. Under the provisions of paragraph 5, a permanent establishment may exist even in the absence of a fixed place of business. If, however, the activities of a person described in paragraph 5 are limited to the ancillary activities described in paragraph 6, then a permanent establishment does not exist solely on account of the person's activities.

There are a number of minor differences between the provisions of paragraphs 1 through 5 and the analagous provisions of the 1942 Convention. One important deviation is elimination of the rule of the 1942 Convention which deems a permanent establishment to exist in any circumstance where a resident of one State uses substantial equipment in the other State for any period of time. The Convention thus generally raises the threshold for source basis taxation of activities that involve substantial equipment (and that do not otherwise constitute a permanent establishment). Another deviation of some significance is elimination of the rule of the 1942 Convention that considers a permanent establishment to exist where a resident of one State carries on business in the other State through an agent or employee who has a stock of merchandise from which he regularly fills orders that he receives. The Convention provides that a person other than an agent of independent status who is engaged solely in the maintenance of a stock of goods or merchandise belonging to a resident of the other State for the purpose of storage, display or delivery does not constitute a permanent establishment.

Paragraph 6 provides that a fixed place of business used solely for, or an employee described in paragraph 5 engaged solely in, certain specified activities is not a permanent establishment, notwithstanding the provisions of paragraphs 1, 2, and 5. The specified activities are: a) the use of facilities for the purpose of storage, display, or delivery of goods or merchandise belonging to the resident whose business is being carried on; b) the maintenance of a stock of goods or merchandise belonging to the resident for the purpose of storage, display, or delivery; c) the maintenance of a stock of goods or merchandise belonging to the resident for the purpose of processing by another person; d) the purchase of goods or merchandise, or the collection of information, for the resident; and e) advertising, the supply of information, scientific research, or similar activities which have a preparatory or auxiliary character, for the resident. Combinations of the specified activities have the same status as any one of the activities. The reference in paragraph 6(e) to specific activities does not imply that any other particular activities -- for example, the servicing of a patent or a know-how contract or the inspection of the implementation of engineering plans -- do not fall within the scope of paragraph 6(e) provided that, based on the facts and circumstances, such activities have a preparatory or auxiliary character.

Paragraph 7 provides that a resident of a Contracting State is not deemed to have a permanent establishment in the other Contracting State merely because such resident carries on business in the other State through a broker, general commission agent, or any other agent of independent status, provided that such persons are acting in the ordinary course of their business.

Paragraph 8 states that the fact that a company which is a resident of one Contracting State controls or is controlled by a company which is either a resident of the other Contracting State or which is carrying on a business in the other State, whether through a permanent establishment or otherwise, does not automatically render either company a permanent establishment of the other.

Paragraph 9 provides that, for purposes of the Convention, the provisions of Article V apply in determining whether any person has a permanent establishment in any State. Thus, these provisions would determine whether a person other than a resident of Canada or the United States has a permanent establishment in Canada or the United States, and whether a person resident in Canada or the United States has a permanent establishment in a third State.

Article VI. INCOME FROM REAL PROPERTY

Paragraph 1 provides that income derived by a resident of a Contracting State from real property situated in the other Contracting State may be taxed by that other State. Income from real property includes, for purposes of Article

VI, income from agriculture or forestry. Also, while "income derived ... from real property" includes income from rights such as an overriding royalty or a net profits interest in a natural resource, it does not include income in the form of rights to explore for or exploit natural resources which a party receives as compensation for services (e.g., exploration services); the latter income is subject to the provisions of Article VII (Business Profits), XIV (Independent Personal Services), or XV (Dependent Personal Services), as the case may be. As provided by paragraph 3, paragraph 1 applies to income derived from the direct use, letting or use in any other form of real property and to income from the alienation of such property.

Generally speaking, the term "real property" has the meaning which it has under the taxation laws of the Contracting State in which the property in question is situated, in accordance with paragraph 2. In any case, the term includes any option or similar right in respect of real property, the usufruct of real property, and rights to explore for or to exploit mineral deposits, sources, and other natural resources. The reference to "rights to explore for or to exploit mineral deposits, sources and other natural resources" includes rights generating either variable or fixed payments. The term "real property" does not include ships and aircraft.

Unlike Article XIII A of the 1942 Convention, Article VI does not contain an election to allow a resident of a Contracting State to compute tax on income from real property situated in the other State on a net basis. Both the Internal Revenue Code and the Income Tax Act of Canada generally allow for net basis taxation with respect to real estate rental income, although Canada does not permit such an election for natural resource royalties. Also, unlike the 1942 Convention which in Article XI imposes a 15 percent limitation on the source basis taxation of rental or royalty income from real property, Article VI of the Convention allows a Contracting State to impose tax on such income under its internal law. In Canada the rate of tax on resource royalties is 25 percent of the gross amount of the royalty, if the income is not attributable to a permanent establishment in Canada under the Convention.

Article VII. BUSINESS PROFITS

Paragraph 1 provides that business profits of a resident of a Contracting State are taxable only in that State unless the resident carries on business in the other Contracting State through a permanent establishment situated in that other State. If the resident carries on, or has carried on, business through such a permanent establishment, the other

State may tax such business profits but only so much of them as are attributable to the permanent establishment. The reference to a prior permanent establishment ("or has carried on") makes clear that a Contracting State in which a permanent establishment existed has the right to tax the business profits attributable to that permanent establishment, even if there is a delay in the receipt or accrual of such profits until after the permanent establishment has been terminated.

Any business profits received or accrued in taxable years in which the Convention has effect, in accordance with Article XXX (Entry Into Force), which are attributable to a permanent establishment that was previously terminated are subject to tax in the Contracting State in which such permanent establishment existed under the provisions of Article VII.

Paragraph 2 provides that where a resident of either Canada or the United States carries on business in the other Contracting State through a permanent establishment in that other State, both Canada and the United States shall attribute to that permanent establishment business profits which the permanent establishment might be expected to make if it were a distinct and separate person engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the resident and with any other person related to the resident. The term "related to the resident" is to be interpreted in accordance with paragraph 2 of Article IX (Related Persons). The reference to other related persons is intended to make clear that the test of paragraph 2 is not restricted to independence between a permanent establishment and a home office.

Paragraph 3 provides that, in determining business profits of a permanent establishment, there are to be allowed as deductions those expenses which are incurred for the purposes of the permanent establishment, including executive and administrative expenses, whether incurred in the State in which the permanent establishment is situated or in any other State. However, nothing in the paragraph requires Canada or the United States to allow a deduction for any expenditure which would not generally be allowed as a deduction under its taxation laws. The language of this provision differs from that of paragraph 1 of Article III of the 1942 Convention, which states that in the determination of net industrial and commercial profits of a permanent establishment there shall be allowed as deductions "all expenses, wherever incurred" as long as such expenses are reasonably allocable to the permanent establishment. Paragraph 3 of Article VII of the Convention is not intended to have any implications for interpretation of the 1942 Convention, but is intended to assure that under the Convention deductions are allowed by a Contracting State which are generally allowable by that State.

Paragraph 4 provides that no business profits are to be attributed to a permanent establishment of a resident of a Contracting State by reason of the use of the permanent establishment for merely purchasing goods or merchandise or merely providing executive, managerial, or administrative facilities or services for the resident. Thus, if a company resident in a Contracting State has a permanent establishment in the other State, and uses the permanent establishment for the mere performance of stewardship or other managerial services carried on for the benefit of the resident, this activity will not result in profits being attributed to the permanent establishment.

Paragraph 5 provides that business profits are to be attributed to a permanent establishment by the same method in every taxable period unless there is good and sufficient reason to change such method. In the United States, such a change may be a change in accounting method requiring the approval of the Internal Revenue Service.

Paragraph 6 explains the relationship between the provisions of Article VII and other provisions of the Convention. Where business profits include items of income which are dealt with separately in other Articles of the Convention, those other Articles are controlling.

Paragraph 7 provides a definition for the term "attributable to." Profits "attributable to" a permanent establishment are those derived from the assets or activities of the permanent establishment. Paragraph 7 does not preclude Canada or the United States from using appropriate domestic tax law rules of attribution. The "attributable to" definition does not, for example, preclude a taxpayer from using the rules of section 1.864-4(c)(5) of the Treasury Regulations to assure for U.S. tax purposes that interest arising in the United States is attributable to a permanent establishment in the United States. (Interest arising outside the United States is attributable to a permanent establishment in the United States based on the principles of Regulations sections 1.864-5 and 1.864-6 and Revenue Ruling 75-253, 1975-2 C.B. 203.) Income that would be taxable under the Code and that is "attributable to" a permanent establishment under paragraph 7 is taxable pursuant to Article VII, however, even if such income might under the Code be treated as fixed or determinable annual or periodical gains or income not effectively connected with the conduct of a trade or business within the United States. The "attributable to" definition means that the limited "force-of-attraction" rule of Code section 864(c)(3) does not apply for U.S. tax purposes under the Convention.

Article VIII. TRANSPORTATION

Paragraph 1 provides that profits derived by a resident of a Contracting State from the operation of ships or aircraft in international traffic are exempt from tax in the other Contracting State, even if, under Article VII (Business Profits), such profits are attributable to a permanent establishment. Paragraph 1 also provides that gains derived by a resident of a Contracting State from the alienation of ships or aircraft used principally in international traffic are exempt from tax in the other Contracting State even if, under Article XIII (Gains), those gains would be taxable in that other State. These rules differ from Article V of the 1942 Convention, which conditions the exemption in the State of source on registration of the ship or aircraft in the other State.

Paragraph 2(a) provides that profits covered by paragraph 1 include profits from the rental of ships or aircraft operated in international traffic. Such rental profits are included whether the rental is on a time, voyage, or bareboat basis, and irrespective of the State of residence of the operator.

Paragraph 2(b) provides that profits covered by paragraph 1 include profits derived from the use, maintenance or rental of containers, including trailers and related equipment for the transport of containers, if such containers are used in international traffic.

Paragraph 2(c) provides that profits covered by paragraph 1 include profits derived by a resident of a Contracting State from the rental of ships, aircraft, or containers (including trailers and related equipment for the transport of containers), even if not operated in international traffic, as long as such profits are incidental to profits of such person referred to in paragraphs 1, 2(a), or 2(b).

To the extent that profits described in paragraph 2 would also fall within Article XII (Royalties) (e.g., rent from the lease of a container), the provisions of Article VIII are controlling.

Paragraph 3 states that profits derived by a resident of a Contracting State from a voyage of a ship where the principal purpose of the voyage is to transport passengers or property between points in the other Contracting State is taxable in that other State, whether or not the resident maintains a permanent establishment there. Paragraph 3 overrides the provisions of Article VII. Profits from such a voyage do not qualify for exemption under Article VIII by virtue of the definition of "international traffic" in paragraph 1(h) of Article III (General Definitions). However, profits from a similar voyage by aircraft are taxable in the Contracting State of source only if the profits are attributable to a permanent establishment maintained in that State.

Paragraph 4 provides that profits derived by a resident of a Contracting State engaged in the operation of motor vehicles or a railway as a common carrier or contract carrier, and attributable to the transportation of passengers or property between a point outside the other Contracting State and any other point are exempt from tax in that other State. In addition, profits of such a person from the rental of motor vehicles (including trailers) or railway rolling stock, or from the use, maintenance, or rental of containers (including trailers and related equipment for the transport of containers) used to transport passengers or property between a point outside the other Contracting State and any other point are exempt from tax in that other State.

Paragraph 5 provides that a resident of a Contracting State that participates in a pool, a joint business, or an international operating agency is subject to the provisions of paragraphs 1, 3, and 4 with respect to the profits or gains referred to in paragraphs 1, 3, and 4.

Paragraph 6 states that profits derived by a resident of a Contracting State from the use, maintenance, or rental of railway rolling stock, motor vehicles, trailers, or containers (including trailers and related equipment for the transport of containers) used in the other Contracting State for a period not expected to exceed 183 days in the aggregate in any 12-month period are exempt from tax in that other State except to the extent that the profits are attributable to a permanent establishment, in which case the State of source has the right to tax under Article VII. The provisions of paragraph 6, unlike the provisions of paragraph 4, apply whether or not the resident is engaged in the operation of motor vehicles or a railway as a common carrier or contract carrier. Paragraph 6 overrides the provisions of Article XII (Royalties), which would otherwise permit taxation in the State of source in the circumstances described.

Gains from the alienation of motor vehicles and railway rolling stock derived by a resident of a Contracting State are not affected by paragraph 4 or 6. Such gains would be taxable in the other Contracting State, however, only if the motor vehicles or rolling stock formed part of a permanent establishment maintained there. See paragraphs 2 and 4 of Article XIII.

Article IX. RELATED PERSONS

Paragraph 1 authorizes Canada and the United States, as the case may be, to adjust the amount of income, loss, or tax payable by a person with respect to arrangements between that person and a related person in the other Contracting State. Such adjustment may be made when arrangements between related persons differ from those that would obtain between unrelated persons. The term "person" encompasses a company resident in a third State with, for example, a permanent establishment in a Contracting State.

Paragraph 2 provides that, for the purposes of Article IX, a person is deemed to be related to another person if either participates directly or indirectly in the management or control of the other or if any third person or persons participate directly or indirectly in the management or control of both. Thus, if a resident of any State controls directly or indirectly a company resident in Canada and a company resident in the United States, such companies are considered to be related persons for purposes of Article IX. Article IX and the definition of "related person" in paragraph 2 may encompass situations that would not be covered by provisions in the domestic laws of the Contracting States. Nor is the paragraph 2 definition controlling for the definition of "related person" or similar terms appearing in other Articles of the Convention. Those terms are defined as provided in paragraph 2 of Article III (General Definitions).

Paragraph 3 provides that where, pursuant to paragraph 1, an adjustment is made or to be made by a Contracting State, the other Contracting State shall make a corresponding adjustment to the income, loss, or tax of the related person in that other State, provided that the other State agrees with the adjustment and, within six years from the end of the taxable year of the person in the first State to which the adjustment relates, the competent authority of the other State has been notified in writing of the adjustment. The reference to an adjustment which "is made or to be made" does not require a Contracting State to formally propose an adjustment before paragraph 3 becomes pertinent. The notification required by paragraph 3 may be made by any of the related persons involved or by the competent authority of the State which makes or is to make the initial adjustment. The notification must give details regarding the adjustment sufficient to apprise the competent authority receiving the notification of the nature of the adjustment. If the requirements of paragraph 3 are complied with, the corresponding adjustment will be made by the other Contracting State notwithstanding any time or procedural limitations in the domestic law of that State.

Paragraph 4 provides that in a case where the other Contracting State has not been notified as provided in paragraph 3 and if the person whose income, loss, or tax is being adjusted has not received notification of the adjustment within five and one-half years from the end of its taxable year to which the adjustment relates, such adjustment shall not be made to the extent that the adjustment would give rise to double taxation between the United States and Canada. Again, the notification referred to in this paragraph need not be a formal adjustment, but it must be in writing and must contain sufficient details to permit the taxpayer to give the notification referred to in paragraph 3.

If, for example, the Internal Revenue Service proposes to make an adjustment to the income of a U.S. company pursuant to Code section 482, and the adjustment involves an allocation of income from a related Canadian company, the competent authority of Canada must receive written notification of the proposed IRS adjustment within six years from the end of the taxable year of the U.S. company to which the adjustment relates. If such notification is not received in a timely fashion and if the U.S. company does not receive written notification of the adjustment from the IRS within 5-1/2 years from the end of its relevant taxable year, the IRS will unilaterally recede on the proposed section 482 adjustment to the extent that this adjustment would otherwise give rise to double taxation between the United States and Canada. The Internal Revenue Service will determine whether and to what extent the adjustment would give rise to double taxation with respect to income arising in Canada by examining the relevant facts and circumstances such as the amount of foreign tax credits attributable to Canadian taxes paid by the U.S. company, including any carryovers and credits for deemed paid taxes.

Paragraph 5 provides that neither a corresponding adjustment described in paragraph 3 nor the cancelling of an adjustment described in paragraph 4 will be made in any case of fraud, willful default, neglect, or gross negligence on the part of the taxpayer or any related person.

Paragraphs 3 and 4 of Article IX are exceptions to the "saving clause" contained in paragraph 2 of Article XXIX (Miscellaneous Rules), as provided in paragraph 3(a) of Article XXIX. Paragraphs 3 and 4 of Article IX apply to adjustments made or to be made with respect to taxable years for which the Convention has effect as provided in paragraphs 2 and 5 of Article XXX (Entry Into Force).

Article X. DIVIDENDS

Paragraph 1 allows a Contracting State to impose tax on its residents with respect to dividends paid by a company which is a resident of the other Contracting State.

Paragraph 2 limits the amount of tax that may be imposed on such dividends by the Contracting State in which the company paying the dividends is resident if the beneficial owner of the dividends is a resident of the other Contracting State. The limitation is 10 percent of the gross amount of the dividends if the beneficial owner is a company that owns 10 percent or more of the voting stock of the company paying the dividends; and 15 percent of the gross amount of the dividends in all other cases. Paragraph 2 does not impose any restrictions with respect to taxation of the profits out of which the dividends are paid.

Paragraph 3 defines the term "dividends," as the term is used in this Article. Each Contracting State is permitted to apply its domestic law rules for differentiating dividends from interest and other disbursements.

Paragraph 4 provides that the limitations of paragraph 2 do not apply if the beneficial owner of the dividends carries on business in the State in which the company paying the dividends is a resident through a permanent establishment or fixed base situated there, and the stockholding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such a case, the dividends are taxable pursuant to the provisions of Article VII (Business Profits) or Article XIV (Independent Personal Services), as the case may be. Thus, dividends paid in respect of holdings forming part of the assets of a permanent establishment or fixed base or which are otherwise effectively connected with such permanent establishment or fixed base (i.e., dividends attributable to the permanent establishment or fixed base) will be taxed on a net basis using the rates and rules of taxation generally applicable to residents of the State in which the permanent establishment or fixed base is situated.

Paragraph 5 imposes limitations on the right of Canada or the United States, as the case may be, to impose tax on dividends paid by a company which is a resident of the other Contracting State. The State in which the company is not resident may not tax such dividends except insofar as they are paid to a resident of that State or the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or fixed base in that State. In the case of the United States, such dividends may also be taxed in the hands of a U.S. citizen and certain former citizens, pursuant to the "saving clause" of paragraph 2 of Article XXIX (Miscellaneous Rules). In addition, the Contracting State in which the company is not resident may not subject such company's undistributed profits to any tax. See, however, paragraphs 6, 7, and 8 which, in certain circumstances, qualify the rules of paragraph 5. Neither paragraph 5 nor any other provision of the Convention restricts the ability of the United States to apply the provisions of the Code concerning foreign personal holding companies and controlled foreign corporations.

Paragraph 6 provides that, notwithstanding paragraph 5, a Contracting State in which is maintained a permanent establishment or permanent establishments of a company resident in the other Contracting State may impose tax on such company's earnings, in addition to the tax that would be charged on the earnings of a company resident in that State. The additional tax may not, however, exceed 10 percent of the amount of the earnings which have not been subjected to such additional tax in previous taxation years. Thus, Canada, which has a branch profits tax in force, may impose that tax up to the 10 percent limitation in the case of a United States company with one or more permanent establishments in Canada. This branch profits tax may be imposed notwithstanding other rules of the Convention, including paragraph 6 of Article XXV (Non-Discrimination).

For purposes of paragraph 6, the term "earnings" means the excess of business profits attributable to all permanent establishments for a year and previous years over the sum of: a) business losses attributable to such permanent establishments for such years; b) all taxes on profits, whether or not covered by the Convention (e g., provincial taxes on profits and provincial resource royalties (which Canada considers "taxes") in excess of the mineral resource allowance provided for under the law of Canada), other than the additional tax referred to in paragraph 6; c) profits reinvested in such State; and d) $500,000 (Canadian, or its equivalent in U.S. dollars) less any amounts deducted under paragraph 6(d) with respect to the same or a similar business by the company or an associated company. The deduction under paragraph 6(d) is available as of the first year for which the Convention has effect, regardless of the prior earnings and tax expenses, if any, of the permanent establishment. The $500,000 deduction is taken into account after other deductions, and is permanent. For the purpose of paragraph 6, references to business profits and business losses include gains and losses from the alienation of property forming part of the business property of a permanent establishment. The term "associated company" includes a company which directly or indirectly controls another company or two companies directly or indirectly controlled by the same person or persons, as well as any two companies that deal with each other not at arm's length. This definition differs from the definition of "related persons" in paragraph 2 of Article IX (Related Persons).

Paragraph 7 provides that, notwithstanding paragraph 5, a Contracting State that does not impose a branch profits tax as described in paragraph 6 (i.e., under current law, the United States) may tax a dividend paid by a company which is a resident of the other Contracting State if at least 50 percent of the company's gross income from all sources was included in the computation of business profits attributable to one or more permanent establishments which such company had in the first-mentioned State. The dividend subject to such a tax must, however, be attributable to profits earned by the company in taxable years beginning after September 26, 1980 and the 50 percent test must be met for the three-year period preceding the taxable year of the company in which the dividend is declared (including years ending on or before September 26, 1980) or such shorter period as the company had been in existence prior to that taxable year. Dividends will be deemed to be distributed, for purposes of paragraph 7, first out of profits of the taxation year of the company in which the distribution is made and then out of the profits of the preceding year or years of the company. Paragraph 7 provides further that if a resident of the other Contracting State is the beneficial owner of such dividends, any tax imposed under paragraph 7 is subject to the 10 or 15 percent limitation of paragraph 2 or the rules of paragraph 4 (providing for dividends to be taxed as business profits or income from independent personal services), as the case may be.

Paragraph 8 provides that, notwithstanding paragraph 5, a company which is a resident of Canada and which, absent the provisions of the Convention, has income subject to tax by the United States may be liable for the United States accumulated earnings tax and personal holding company tax. These taxes can be applied, however, only if 50 percent or more in value of the outstanding voting shares of the company is owned, directly or indirectly, throughout the last half of its taxable year by residents of a third State or by citizens or residents of the United States, other than citizens of Canada who are resident in the United States but who either do not have immigrant status in the United States or who have not been resident in the United States for more than three taxable years. The accumulated earnings tax is applied to accumulated taxable income calculated without the benefits of the Convention. Similarly, the personal holding company tax is applied to undistributed personal holding company income computed as if the Convention had not come into force.

Article X does not apply to dividends paid by a company which is not a resident of either Contracting State. Such dividends, if they are income of a resident of one of the Contracting States, are subject to tax as provided in Article XXII (Other Income).

Article XI. INTEREST

Paragraph 1 allows interest arising in Canada or the United States and paid to a resident of the other State to be taxed in the latter State. Paragraph 2 provides that such interest may also be taxed in the Contracting State where it arises, but if a resident of the other Contracting State is the beneficial owner, the tax imposed by the State of source is limited to 15 percent of the gross amount of the interest.

Paragraph 3 provides a number of exceptions to the right of the source State to impose a 15 percent tax under paragraph 2. The following types of interest beneficially owned by a resident of a Contracting State are exempt from tax in the State of source: a) interest beneficially owned by a Contracting State, a political subdivision, or a local authority thereof, or an instrumentality of such State, subdivision, or authority, which interest is not subject to tax by such State; b) interest beneficially owned by a resident of a Contracting State and paid with respect to debt obligations issued at arm's length which are guaranteed or insured by such State or a political subdivision thereof, or by an instrumentality of such State or subdivision (not by a local authority or an instrumentality thereof), but only if the guarantor or insurer is not subject to tax by that State; c) interest paid by a Contracting State, a political subdivision, or a local authority thereof, or by an instrumentality of such State, subdivision, or authority, but only if the payor is not subject to tax by such State; and d) interest beneficially owned by a seller of equipment, merchandise, or services, but only if the interest is paid in connection with a sale on credit of equipment, merchandise, or services and the sale was made at arm's length. Whether such a transaction is made at arm's length will be determined in the United States under the facts and circumstances. The relationship between the parties is a factor, but not the only factor, taken into account in making this determination. Furthermore, interest paid by a company resident in the other Contracting State with respect to an obligation entered into before September 26, 1980 is exempt from tax in the State of source (irrespective of the State of residence of the beneficial owner), provided that such interest would have been exempt from tax in the Contracting State of source under Article XII of the 1942 Convention. Thus, interest paid by a United States corporation whose business is not managed and controlled in Canada to a recipient not resident in Canada or to a corporation not managed and controlled in Canada would be exempt from Canadian tax as long as the debt obligation was entered into before September 26, 1980. The phrase "not subject to tax by that . . . State" in paragraph 3(a), (b), and (c) refers to taxation at the Federal levels of Canada and the United States.

The phrase "obligation entered into before the date of signature of this Convention" means: (1) any obligation under which funds were dispersed prior to September 26, 1980; (2) any obligation under which funds are dispersed on or after September 26, 1980, pursuant to a written contract binding prior to and on such date, and at all times thereafter until the obligation is satisfied; or (3) any obligation with respect to which, prior to September 26, 1980, a lender had taken every action to signify approval under procedures ordinarily employed by such lender in similar transactions and had sent or deposited for delivery to the person to whom the loan is to be made written evidence of such approval in the form of a document setting forth, or referring to a document sent by the person to whom the loan is to be made that sets forth, the principal terms of such loan.

Paragraph 4 defines the term "interest," as used in Article XI, to include, among other things, debt claims of every kind as well as income assimilated to income from money lent by the taxation laws of the Contracting State in which the income arises. In no event, however, is income dealt with in Article X (Dividends) to be considered interest.

Paragraph 5 provides that neither the 15 percent limitation on tax in the Contracting State of source provided in paragraph 2 nor the various exemptions from tax in such State provided in paragraph 3 apply if the beneficial owner of the interest is a resident of the other Contracting State carrying on business in the State of source through a permanent establishment or fixed base, and the debt claim in respect of which the interest is paid is effectively connected with such permanent establishment or fixed base (i.e., the interest is attributable to the permanent establishment or fixed base). In this case, interest income is to be taxed in the Contracting State of source as business profits -- that is, on a net basis.

Paragraph 6 establishes the source of interest for purposes of Article XI. Interest is considered to arise in a Contracting State if the payer is that State, or a political subdivision, local authority, or resident of that State. However, in cases where the person paying the interest, whether a resident of a Contracting State or of a third

State, has in a State other than that of which he is a resident a permanent establishment or fixed base in connection with which the indebtedness on which the interest was paid was incurred, and such interest is borne by the permanent establishment or fixed base, then such interest is deemed to arise in the State in which the permanent establishment or fixed base is situated and not in the State of the payer's residence. Thus, pursuant to paragraphs 6 and 2, and Article XXII (Other Income), Canadian tax will not be imposed on interest paid to a U.S. resident by a company resident in Canada if the indebtedness is incurred in connection with, and the interest is borne by, a permanent establishment of the company situated in a third State. "Borne by" means allowable as a deduction in computing taxable income.

Paragraph 7 provides that in cases involving special relationships between persons Article XI does not apply to amounts in excess of the amount which would have been agreed upon between persons having no special relationship; any such excess amount remains taxable according to the laws of Canada and the United States, consistent with any revelant provisions of the Convention.

Paragraph 8 restricts the right of a Contracting State to impose tax on interest paid by a resident of the other Contracting State. The first State may not impose any tax on such interest except insofar as the interest is paid to a resident of that State or arises in that State or the debt claim in respect of which the interest is paid is effectively connected with a permanent establishment or fixed base situated in that State. Thus, pursuant to paragraph 8 the United States has agreed not to impose tax on certain interest paid by Canadian companies to persons not resident in the United States, to the extent that such companies would pay U.S. source interest under Code section 861(a)(1)(C) but not under the source rule of paragraph 6. It is to be noted that paragraph 8 is subject to the "saving clause" of paragraph 2 of Article XXIX (Miscellaneous Rules), so the United States may in all events impose its tax on interest received by U.S. citizens.

Article XII. ROYALTIES

Generally speaking, under the 1942 Convention royalties, including royalties with respect to motion picture films, which are derived by a resident of one Contracting State from sources within the other Contracting State are taxed at a maximum rate of 15 percent in the latter State; copyright royalties are exempt from tax in the State of source, if the resident does not have a permanent establishment in that State. See Articles II, III, XIII C, and paragraph 1 of Article XI of the 1942 Convention, and paragraph 6(a) of the Protocol to the 1942 Convention.

Paragraph 1 of Article XII of the Convention provides that a Contracting State may tax its residents with respect to royalties arising in the other Contracting State. Paragraph 2 provides that such royalties may also be taxed in the Contracting State in which they arise, but that if a resident of the other Contracting State is the beneficial owner of the royalties the tax in the Contracting State of source is limited to 10 percent of the gross amount of the royalties.

Paragraph 3 provides that, notwithstanding paragraph 2, copyright royalties and other like payments in respect of the production or reproduction of any literary, dramatic, musical, or artistic work, including royalties from such works on videotape cassettes for private (home) use, if beneficially owned by a resident of the other Contracting State, may not be taxed by the Contracting State of source. This exemption at source does not apply to royalties in respect of motion picture films and works on film or videotape for use in connection with television broadcasting. Such royalties are subject to tax at a maximum rate of 10 percent in the Contracting State in which they arise, as provided in paragraph 2 (unless the provisions of paragraph 5, described below, apply).

Paragraph 4 defines the term "royalties" for purposes of Article XII. "Royalties" means payments of any kind received as consideration for the use of or the right to use any copyright of literary, artistic, or scientific work, including motion picture films and works on film or videotape for private (home) use or for use in connection with television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or any payment for the use of or the right to use tangible personal property or for information concerning industrial, commercial, or scientific experience. The term "royalties" also includes gains from the alienation of any intangible property or rights described in paragraph 4 to the extent that such gains are contingent on the productivity, use, or subsequent disposition of such intangible property or rights. Thus, a guaranteed minimum payment derived from the alienation of (but not the use of) any right or property described in paragraph 4 is not a "royalty." Any amounts deemed contingent on use by reason of Code section 871(e) are, however, royalties under paragraph 2 of Article III (General Definitions), subject to Article XXVI (Mutual Agreement Procedure). The term "royalties" does not encompass management fees, which are covered by the provisions of Article VII (Business Profits) or XIV (Independent Personal Services), or payments under a bona fide cost-sharing arrangement. Technical service fees may be royalties in cases where the fees are periodic and dependent upon productivity or a similar measure.

Paragraph 5 provides that the 10 percent limitation on tax in the Contracting State of source provided by paragraph 2, and the exemption in the Contracting State of source for certain copyright royalties provided by paragraph 3, do not apply if the beneficial owner of the royalties carries on business in the State of source through a permanent establishment or fixed base and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base (i.e., the royalties are attributable to the permanent establishment or fixed base). In that event, the royalty income would be taxable under the provisions of Article VII (Business Profits) or XIV (Independent Personal Services), as the case may be.

Paragraph 6 establishes rules to determine the source of royalties for purposes of Article XII. The first rule is that royalties arise in a Contracting State when the payer is that State, or a political subdivision, local authority, or resident of that State. Notwithstanding that rule, royalties arise not in the State of the payer's residence but in any State, whether or not a Contracting State, in which is situated a permanent establishment or fixed base in connection with which the obligation to pay royalties was incurred, if such royalties are borne by such permanent establishment or fixed base. Thus, royalties paid to a resident of the United States by a company resident in Canada for the use of property in a third State will not be subject to tax in Canada if the obligation to pay the royalties is incurred in connection with, and the royalties are borne by, a permanent establishment of the company in a third State. "Borne by" means allowable as a deduction in computing taxable income.

A third rule, which overrides both the residence rule and the permanent establishment rule just described, provides that royalties for the use of intangible property or tangible personal property arise in the Contracting State in which such property is used. Thus, consistent with the provisions of Code section 861(a)(4), if a resident of a third State pays royalties to a resident of Canada for the right to use intangible property in the United States, such royalties are considered to arise in the United States and are subject to taxation by the United States consistent with the Convention. Similarly, if a resident of Canada pays royalties to a resident of a third State, such royalties are considered to arise in the United States and are subject to U.S. taxation if they are for the right to use intangible property in the United States. The term "intangible property" encompasses all the items described in paragraph 4, other than tangible personal property.

Paragraph 7 provides that in cases involving special relationships between persons the benefits of Article XII do not apply to amounts in excess of the amount which would have been agreed upon between persons with no special relationship; any such excess amount remains taxable according to the laws of Canada and the United States, consistent with any relevant provisions of the Convention.

Paragraph 8 restricts the right of a Contracting State to impose tax on royalties paid by a resident of the other Contracting State. The first State may not impose any tax on such royalties except insofar as they arise in that State or they are paid to a resident of that State or the right or property in respect of which the royalties are paid is effectively connected with a permanent establishment or fixed base situated in that State. This rule parallels the rule in paragraph 8 of Article XI (Interest) and paragraph 5 of Article X (Dividends). Again, U.S. citizens remain subject to U.S. taxation on royalties received despite this rule, by virtue of paragraph 2 of Article XXIX (Miscellaneous Rules).

Article XIII. GAINS

Paragraph 1 provides that Canada and the United States may each tax gains from the alienation of real property situated within that State which are derived by a resident of the other Contracting State. The term "real property" is defined for this purpose in paragraph 2 of Article VI (Income From Real Property). The term "alienation" used in paragraph 1 and other paragraphs of Article XIII means sales, exchanges and other dispositions or deemed dispositions (e.g., change of use, gifts, death) that are taxable events under the taxation laws of the Contracting State applying the provisions of the Article.

Paragraph 2 of Article XIII provides that the Contracting State in which a resident of the other Contracting State "has or had" a permanent establishment or fixed base may tax gains from the alienation of personal property constituting business property if such gains are attributable to such permanent establishment or fixed base. Unlike paragraph 1 of Article VII (Business Profits), paragraph 2 limits the right of the source State to tax such gains to a twelve-month period following the termination of the permanent establishment or fixed base.

Paragraph 3 authorizes the Contracting State of source to tax gains derived from the alienation of certain stock and other interests, if such interests ultimately reflect value derived from real property situated in that State. The right to tax in the State of source applies when there is an alienation of either shares forming part of a substantial interest in the capital stock of a company which is not a resident of the taxpayer's State of residence, or an interest in a partnership, trust, or estate, but only if the value of such shares or interest, as the case may be, is derived principally from real property in the Contracting State of source. The term "principally" means more than 50 percent. The right accorded to the State of source depends, however, on the domestic law in force in the Contracting State of residence. Thus, if at the time of alienation the latter State does not, by reason of its domestic law, impose tax upon gains derived from the alienation of a class of shares or interests (such as shares in companies which are not residents of that State), then the State of source may not impose tax in reciprocal circumstances.

Subparagraph (c) of paragraph 3 provides that the term "real property" as used in the paragraph, does not include property -- other than mines, oil or gas wells, rental property, or property used for agriculture or forestry -- in which a business is carried on. The term does include the shares of a company which derive their value principally from real property (wherever located) and an interest in a partnership, trust, or estate the direct disposition of which would be subject to tax under the paragraph. Thus, taxation in the Contracting State of source is preserved through several tiers of entities if the value of the shares or interest alienated is ultimately dependent principally upon real property in that State.

A "substantial interest" exists only if, on or after the effective date of the Convention provided in Article XXX (Entry Into Force), the resident and any persons related to him own 10 percent or more of the shares of any class of the capital stock of a company. It is the intention that once a "substantial interest" exists, all stock that is part of such "substantial interest" is covered by paragraph 3, even if the percentage of ownership declines to less than 10 percent. The term "related persons" is not defined by the rules of Article IX (Related Persons); rather, the term is defined pursuant to paragraph 2 of Article III (General Definitions).

Paragraph 4 reserves to the Contracting State of residence the sole right to tax gains from the alienation of any property other than property referred to in paragraphs 1, 2, and 3.

Paragraph 5 states that, despite paragraph 4, a Contracting State may impose tax on gains derived by an individual who is a resident of the other Contracting State if such individual was a resident of the first-mentioned State for 120 months (whether or not consecutive) during any period of 20 consecutive years, and was a resident of that State at any time during the 10-year period immediately preceding the alienation of the property.

Paragraph 6 provides a rule to coordinate Canadian and United States taxation of gains from the alienation of a principal residence situated in Canada. An individual (not a citizen of the United States) who was a resident of Canada and becomes a resident of the United States may determine his liability for U.S. income tax purposes in respect of gain from the alienation of a principal residence in Canada owned by him at the time he ceased to be a resident of Canada by claiming an adjusted basis for such residence in an amount no less than the fair market value of the residence at that time. Under paragraph 2(b) of Article XXX, the rule of paragraph 6 applies to gains realized for U.S. income tax purposes in taxable years beginning on or after the first day of January next following the date when instruments of ratification are exchanged, even if a particular individual described in paragraph 6 ceased to be a resident of Canada prior to such date. Paragraph 6 supplements any benefits available to a taxpayer pursuant to the provisions of the Code, e.g., section 1034.

Paragraph 7 provides a rule to coordinate U.S. and Canadian taxation of gains in circumstances where an individual is subject to tax in both Contracting States and one Contracting State deems a taxable alienation of property by such person to have occurred, while the other Contracting State at that time does not find a realization or recognition of income and thus defers, but does not forgive, taxation. In such a case the individual may elect in his annual return of income for the year of such alienation to be liable to tax in the latter Contracting State as if he had sold and repurchased the property for an amount equal to its fair market value at a time immediately prior to the deemed alienation. The provision would, for example, apply in the case of a gift by a U.S. citizen or a U.S. resident individual which Canada deems to be an income producing event for its tax purposes but with respect to which the United States defers taxation while assigning the donor's basis to the donee. The provision would also apply in the case of a U.S. citizen who, for Canadian tax purposes, is deemed to recognize income upon his departure from Canada, but not to a Canadian resident (not a U.S. citizen) who is deemed to recognize such income. The rule does not apply in the case of death, although Canada also deems that to be a taxable event, because the United States in effect forgives income taxation of economic gains at death. If in one Contracting State there are losses and gains from deemed alienations of different properties, then paragraph 7 must be applied consistently in the other Contracting State within the taxable period with respect to all such properties. Paragraph 7 only applies, however, if the deemed alienations of the properties result in a net gain.

Paragraph 8 concerns the coordination of Canadian and U.S. rules with respect to the recognition of gain on corporate organizations, reorganizations, amalgamations, divisions, and similar transactions. Where a resident of a Contracting State alienates property in such a transaction, and profit, gain, or income with respect to such alienation is not recognized for income tax purposes in the Contracting State of residence, the competent authority of the other Contracting State may agree, pursuant to paragraph 8, if requested by the person who acquires the property, to defer recognition of the profit, gain, or income with respect to such property for income tax purposes. This deferral shall be for such time and under such other conditions as are stipulated between the person who acquires the property and the competent authority. The agreement of the competent authority of the State of source is entirely discretionary and will be granted only to the extent necessary to avoid double taxation of income. This provision means, for example, that the United States competent authority may agree to defer recognition of gain with respect to a transaction if the alienator would otherwise recognize gain for U.S. tax purposes and would not recognize gain under Canada's law. The provision only applies, however, if alienations described in paragraph 8 result in a net gain. In the absence of extraordinary circumstances the provisions of the paragraph must be applied consistently within a taxable period with respect to alienations described in the paragraph that take place within that period.

Paragraph 9 provides a transitional rule reflecting the fact that under Article VIII of the 1942 Convention gains from the sale or exchange of capital assets are exempt from taxation in the State of source provided the taxpayer had no permanent establishment in that State. Paragraph 9 applies to property that on September 26, 1980 was owned by a resident of the other Contracting if it did not form part of the business property of a permanent establishment or pertain to a fixed base in the State of source. Paragraph 9 applies to deemed dispositions. In addition, paragraph 9 applies to a gain described in paragraph 1, even though such gain is also income within the meaning of paragraph 3 of Article VI.

Paragraph 9 provides that where a resident of Canada or the United States is subject to tax pursuant to Article XIII in the other Contracting State on gains from the alienation of property, the amount of the gain shall be reduced for tax purposes in that other State by the amount of the gain attributable to the period during which the property was held up to and including December 31 of the year in which the documents of ratification are exchanged. The gain attributable to such period is normally determined by dividing the total gain by the number of full calendar months the property was held by such person, including, in the case of property having a carryover basis, the number of months in which a predecessor in interest held the property, and multiplying such monthly amount by the number of full calendar months ending on or before December 31 of the year in which the instruments of ratification are exchanged. In a case where property with a carryover basis is alienated after September 26, 1980, paragraph 9 applies to the alienator if at the time he sells or exchanges the property he is a person entitled to the benefits of paragraph 9 and his basis in the property is carried over from that of a person who, on September 26, 1980, would have been entitled to claim exemption at source under the 1942 Convention had he sold the property at that time.

Upon a clear showing, however, a taxpayer may prove that a greater portion of the gain was attributable to the specified period. Thus, in the United States the fair market value of the alienated property at the treaty valuation date may be established under paragraph 9 in the manner and with the evidence that is generally required by U.S. Federal income, estate, and gift tax regulations. For this purpose a taxpayer may use valid appraisal techniques for valuing real estate such as the comparable sales approach (see Rev. Proc. 79-24, 1979-1 C.B. 565), and the reproduction cost approach. If more than one property is alienated in a single transaction each property will be considered individually.

A taxpayer who desires to make this alternate showing for U.S. tax purposes must so indicate on his U.S. income tax return for the year of the sale or exchange and must attach to the return a statement describing the relevant evidence. The U.S. competent authority or his authorized delegate will determine whether the taxpayer has satisfied the requirements of paragraph 9.

U.S. residents, citizens and former citizens remain subject to U.S. taxation on gains as provided by the Code notwithstanding the provisions of Article XIII, other than paragraphs 6 and 7. See paragraphs 2 and 3(a) of Article XXIX (Miscellaneous Rules).

Article XIV. INDEPENDENT PERSONAL SERVICES

Article XIV concerns the taxation of income derived by an individual in respect of the performance of independent personal services. Such income may be taxed in the

Contracting State of which such individual is a resident. It may also be taxed in the other Contracting State if the individual has or had a fixed base regularly available to him in the other State for the purpose of performing his activities, but only to the extent that the income is attributable to that fixed base. The use of the term "has or had" ensures that a Contracting State in which a fixed base existed has the right to tax income attributable to that fixed base even if there is a delay between the termination of the fixed base and the receipt or accrual of such income.

Unlike Article VII of the 1942 Convention, which provides a limited exemption from tax at source on income from independent personal services, Article XIV does not restrict the exemption to persons present in the State of source for fewer than 184 days. Furthermore, Article XIV does not allow the $5,000 exemption at source of the 1942 Convention, which was available even if services were performed through a fixed base. However, Article XIV provides complete exemption at source if a fixed base does not exist.

Article XV. DEPENDENT PERSONAL SERVICES

Paragraph 1 provides that, in general, salaries, wages, and other similar remuneration derived by a resident of a Contracting State in respect of an employment are taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is exercised in the other Contracting State, the entire remuneration derived therefrom may be taxed in that other State but only if, as provided by paragraph 2, the recipient is present in the other State for a period or periods exceeding 183 days in the calendar year, or the remuneration is borne by an employer who is a resident of that other State or by a permanent establishment or fixed base which the employer has in that other State. However, in all cases where the employee earns $10,000 or less in the currency of the State of source, such earnings are exempt from tax in that State. "Borne by" means allowable as a deduction in computing taxable income. Thus, if a Canadian resident individual employed at the Canadian permanent establishment of a U.S. company performs services in the United States, the income earned by the employee from such services is not exempt from U.S. tax under paragraph 1 if such income exceeds $10,000 (U.S.) because the U.S. company is entitled to a deduction for such wages in computing its taxable income.

Paragraph 3 provides that a resident of a Contracting State is exempt from tax in the other Contracting State with respect to remuneration derived in respect of an employment regularly exercised in more than one State on a ship, aircraft, motor vehicle, or train operated by a resident of the taxpayer's State of residence. The word "regularly" is intended to distinguish crew members from persons occasionally employed on a ship, aircraft, motor vehicle, or train. Only the Contracting State of which the employee and operator are resident has the right to tax such remuneration. However, this provision is subject to the "saving clause" of paragraph 2 of Article XXIX (Miscellaneous Rules), which permits the United States to tax its citizens despite paragraph 3.

Article XV states that its provisions are overridden by the more specific rules of Article XVIII (Pensions and Annuities) and Article XIX (Government Services).

Article XVI. ARTISTES AND ATHLETES

Article XVI concerns income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio, or television artiste, or a musician, or as an athlete, from his personal activities as such exercised in the other Contracting State. Article XVI overrides Articles XIV (Independent Personal Services) and XV (Dependent Personal Services) to allow source basis taxation of an entertainer or athlete in cases where the latter Articles would not permit such taxation. Thus, paragraph 1 provides that certain income of an entertainer or athlete may be taxed in the State of source in all cases where the amount of gross receipts derived by the entertainer or athlete, including expenses reimbursed to him or borne on his behalf, exceeds $15,000 in the currency of that other State for the calendar year concerned. For example, where a resident of Canada who is an entertainer derives income from his personal activities as an entertainer in the United States, he is taxable in the United States on all such income in any case where his gross receipts are greater than $15,000 for the calendar year. Article XVI does not restrict the right of the State of source to apply the provisions of Articles XIV and XV. Thus, an entertainer or athlete resident in a Contracting State and earning $14,000 in wages borne by a permanent establishment in the other State may be taxed in the other State as provided in Article XV.

Paragraph 2 provides that where income in respect of personal activities exercised by an entertainer or an athlete accrues not to the entertainer or athlete himself but to another person, that income may, notwithstanding the provisions of Article VII (Business Profits), Article XIV, and Article XV, be taxed in the Contracting State in which the activities are exercised. The anti-avoidance rule of paragraph 2 does not apply if it is established by the entertainer or athlete that neither he nor persons related to him participate directly or indirectly in the profits of the other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions, or other distributions.

Thus, if an entertainer who is a resident of Canada is under contract with a company and the arrangement between the entertainer and the company provides for payments to the entertainer based on the profits of the company, all of the income of the company attributable to the performer's U.S. activities may be taxed in the United States irrespective of whether the company maintains a permanent establishment in the United States. Paragraph 2 does not affect the rule of paragraph 1 that applies to the entertainer or athlete himself.

Paragraph 3 provides that Article XVI does not apply to the income of an athlete in respect of an employment with a team which participates in a league with regularly scheduled games in both Canada and the United States. Such an athlete is entitled to the benefits of Article XV (Dependent Personal Services). Thus, the athlete's remuneration would be exempt from tax in the Contracting State of source if he is a resident of the other Contracting State and earns $10,000 or less in the currency of the State of source, or if he is present in that State for a period or periods not exceeding in the aggregate 183 days in the calendar year, and his remuneration is not borne by a resident of that State or a permanent establishment or fixed base in that State. Paragraph 3 does not affect the taxation of the employer of an athlete covered by the paragraph. The employer is taxable pursuant to other articles of the Convention, such as Article VII.

Article XVII. WITHHOLDING OF TAXES IN RESPECT OF INDEPENDENT PERSONAL SERVICES

Article XVII confirms that a Contracting State may require withholding of tax on account of tax liability with respect to remuneration paid to an individual who is a resident of the other Contracting State, including an entertainer or athlete, in respect of the performance of independent personal services in the first-mentioned State. However, withholding with respect to the first $5,000 (in the currency of the State of source) of such remuneration paid in that taxable year by each payor shall not exceed 10 percent of such payment. In the United States, the withholding described in paragraph 1 relates to withholding with respect to income tax liability and does not relate to withholding with respect to other taxes, such as social security taxes. Nor is the paragraph intended to suggest that withholding in circumstances not specifically mentioned, such as withholding with respect to dependent personal services, is precluded by the Convention.

Paragraph 2 provides that in any case where the competent authority of Canada or the United States believes that withholding with respect to remuneration for the performance of independent personal services is excessive in relation to the estimated tax liability of an individual to that State for a taxable year, it may determine that a lesser amount will be deducted or withheld. Paragraph 2 may thus result in a lesser withholding than the maximum authorized by paragraph 1.

Paragraph 3 states that the provisions of Article XVII do not affect the liability of a resident of a Contracting State for taxes imposed by the other Contracting State. The Article deals only with the method of collecting taxes and not with substantive tax liability.

Article XVIII A of the 1942 Convention authorizes the issuance of regulations to specify circumstances under which residents of the United States temporarily performing personal services in Canada may be exempted from deduction and withholding of United States tax. This provision is omitted from the Convention as unnecessary. The Code and regulations provide sufficient authority to avoid excessive withholding of U.S. income tax.

Article XVIII. PENSIONS AND ANNUITIES

Paragraph 1 provides that a resident of a Contracting State is taxable in that State with respect to pensions and annuities arising in the other Contracting State. However, the amount of any pension included in such person's income is not to exceed the amount that would be included if the person were a resident of the Contracting State in which the pension arises. Paragraph 1 imposes no such restriction with respect to the amount that may be taxed in the State of residence in the case of annuities.

Paragraph 2 provides rules with respect to the taxation of pensions and annuities in the Contracting State in which they arise. If the beneficial owner of a periodic pension payment is a resident of the other Contracting State, the tax imposed in the State of source is limited to 15 percent of the gross amount of such payment. Thus, the State of source is not required to allow a deduction or exclusion for a return of capital to the pensioner, but its tax is limited in amount in the case of a periodic payment. Other pension payments may be taxed in the State of source without limit.

In the case of annuities beneficially owned by a resident of a Contracting State, the Contracting State of source is limited to a 15 percent tax on the portion of the payment that is liable to tax in that State under its taxation laws.

Paragraph 3 defines the term "pensions" for purposes of the Convention to include any payment under a superannuation, pension, or retirement plan, Armed-Forces retirement pay, war veterans pensions and allowances, and amounts paid under a sickness, accident, or disability plan. Thus, the term "pension" includes pensions paid by private employers as well as any pension paid by a Contracting State in respect of services rendered to that State. A pension for government service is covered. The term "pensions" does not include payments under an income averaging annuity contract or benefits paid under social security legislation. The latter benefits are taxed, pursuant to paragraph 5, only in the Contracting State paying the benefit. Income derived from an income averaging annuity contract is taxable pursuant to the provisions of Article XXII (Other Income).

Paragraph 4 provides that, for purposes of the Convention, the term "annuities" means a stated sum paid periodically at stated times during life or during a specified number of years, under an obligation to make payments in return for adequate and full consideration other than services rendered. The term does not include a payment that is not periodic or any annuity the cost of which was deductible for tax purposes in the Contracting State where the annuity was acquired. Items excluded from the definition of "annuities" are subject to the rules of Article XXII.

Paragraph 5 provides that benefits under social security legislation in Canada or the United States paid to a resident of the other Contracting State or to a citizen of the United States are taxable only in the Contracting State paying the benefit. Paragraph 5 encompasses benefits paid under social security legislation of a political subdivision, such as a province of Canada.

Paragraph 6 provides that only the State of which a person is resident has the right to tax alimony and other similar amounts (including child support payments) arising in the other Contracting State and paid to such person. However, the amount included in income for purposes of taxation in the State of residence is not to exceed the amount that would be included in income if the recipient were a resident of the Contracting State of source. Paragraph 6 does not define the term "alimony"; the term is defined pursuant to the provisions of paragraph 2 of Article III (General Definitions).

Article XVIII does not provide rules to determine the State in which pensions, annuities, alimony, and other similar amounts arise. The provisions of paragraph 2 of Article III are used to determine where such amounts arise for purposes of determining whether a Contracting State has the right to tax such amounts.

The entirety of Article XVIII is, by reason of paragraph 3(a) of Article XXIX (Miscellaneous Rules), an exception to the "saving clause." Thus, the rules in this Article change U.S. taxation of U.S. citizens and residents.

Article XIX. GOVERNMENT SERVICE

Article XIX provides that remuneration, other than a pension, paid by a Contracting State or politicial subdivision or local authority thereof to a citizen of that State in respect of services rendered in the discharge of governmental functions shall be taxable only in that State. (Pursuant to paragraph 5 of Article IV (Residence), other income of such a citizen may also be exempt from tax, or subject to reduced rates of tax, in the State in which he is performing services, in accordance with other provisions of the Convention.) However, if the services are rendered in connection with a trade or business, then the provisions of Article XIV (Independent Personal Services), Article XV (Dependent Personal Services), or Article XVI (Artistes and Athletes), as the case may be, are controlling. Whether functions are of a governmental nature may be determined by a comparison with the concept of a governmental function in the State in which the income arises.

Pursuant to paragraph 3(a) of Article XXIX (Miscellaneous Rules), Article XIX is an exception to the "saving clause." As a result, a U.S. citizen resident in Canada and performing services in Canada in the discharge of functions of a governmental nature for the United States is taxable only in the United States on remuneration for such services.

This provision differs from the rules of Article VI of the 1942 Convention. For example, Article XIX allows the United States to impose tax on a person other than a citizen of Canada who earns remuneration paid by Canada in respect of services rendered in the discharge of governmental functions in the United States. (Such a person may, however, be entitled to an exemption from U.S. tax as provided in Code section 893.) Also, under the provisions of Article XIX Canada will not impose tax on amounts paid by the United States in respect of services rendered in the discharge of governmental functions to a U.S. citizen who is ordinarily resident in Canada for purposes other than rendering governmental services. Under paragraph 1 of Article VI of the 1942 Convention, such amounts would be taxable by Canada.

Article XX. STUDENTS

Article XX provides that a student, apprentice, or business trainee temporarily present in a Contracting State for the purpose of his full-time education or training is exempt from tax in that State with respect to amounts received from outside that State for the purpose of his maintenance, education, or training, if the individual is or was a resident of the other Contracting State immediately before visiting the first-mentioned State. There is no limitation on the number of years or the amount of income to which the exemption applies.

The Convention does not contain provisions relating specifically to professors and teachers. Teachers are treated under the Convention pursuant to the rules established in Articles XIV (Independent Personal Services) and XV (Dependent Personal Services), in the same manner as other persons performing services. In Article VIII A of the 1942 Convention there is a 2-year exemption in the Contracting State of source in the case of a professor or teacher who is a resident of the other Contracting State.

Article XXI. EXEMPT ORGANIZATIONS

Paragraph 1 provides that a religious, scientific, literary, educational, or charitable organization resident in a Contracting State shall be exempt from tax on income arising in the other Contracting State but only to the extent that such income is exempt from taxation in the Contracting State in which the organization is resident. Since this paragraph, and the remainder of Article XXI, deal with entities that are not normally taxable, the test of "resident in" is intended to be similar - but cannot be identical - to the one outlined in paragraph 1 of Article IV (Residence). Paragraph 3 provides that paragraph 1 does not exempt from tax income of a trust, company, or other organization from carrying on a trade or business, or income from a "related person" other than a person referred to in paragraph 1 or 2.

Paragraph 2 provides that a trust, company, or other organization that is resident in a Contracting State and constituted and operated exclusively to administer or provide employee benefits or benefits for the self-employed under one or more funds or plans established to provide pension or retirement benefits or other employee benefits is exempt from taxation on dividend and interest income arising in the other Contracting State, if the income of such organization is generally exempt from taxation in the Contracting State in which it is resident. Pursuant to paragraph 3 the exemption at source provided by paragraph 2 does not apply to dividends or interest from carrying on a trade or business or from a "related person," other than a person referred to in paragraph 1 or 2. The term "related person" is not necessarily defined by paragraph 2 of Article IX (Related Persons).

Paragraph 4 provides an exemption from U.S. excise taxes on private foundations in the case of a religious, scientific, literary, educational, or charitable organization which is resident in Canada but only if such organization has received substantially all of its support from persons other than citizens or residents of the United States.

Paragraph 5 provides that contributions by a citizen or resident of the United States to an organization which is resident in Canada and is generally exempt from Canadian tax are treated as charitable contributions, but only if the organization could qualify in the United States to receive deductible contributions if it were resident in (i.e., organized in) the United States. Paragraph 5 generally limits the amount of contributions made deductible by the Convention to the income of the U.S. citizen or resident arising in Canada, as determined under the Convention. In the case of contributions to a college or university at which the U.S. citizen or resident or a member of his family is or was enrolled, the special limitation to income arising in Canada is not required. The percentage limitations of Code section 170 in respect of the deductibility of charitable contributions apply after the limitations established by the Convention. Any amounts treated as charitable contributions by paragraph 5 which are in excess of amounts deductible in a taxable year pursuant to paragraph 5 may be carried over and deducted in subsequent taxable years, subject to the limitations of paragraph 5.

Paragraph 6 provides rules for purposes of Canadian taxation with respect to the deductibility of gifts to a U.S. resident organization by a resident of Canada. The rules of paragraph 6 parallel the rules of paragraph 5. The current limitations in Canadian law provide that deductions for gifts to charitable organizations may not exceed 20 percent of income. Excess deductions may be carried forward for one year.

The term "family" used in paragraphs 5 and 6 is defined in paragraph 2 of the Exchange of Notes accompanying the Convention to mean an individual's brothers and sisters (whether by whole or half-blood, or by adoption), spouse, ancestors, lineal descendents, and adopted descendents. Paragraph 2 of the Exchange of Notes also provides that the competent authorities of Canada and the United States will review procedures and requirements for organizations to establish their exempt status under paragraph 1 of Article XXI or as an eligible recipient of charitable contributions or gifts under paragraphs 5 and 6 of Article XXI. It is contemplated that such review will lead to the avoidance of duplicative administrative efforts in determining such status and eligibility.

The provisions of paragraph 5 and 6 generally parallel the rules of Article XIII D of the 1942 Convention. However, paragraphs 5 and 6 permit greater deductions for certain contributions to colleges and universities than do the provisions of the 1942 Convention.

Article XXII. OTHER INCOME

Paragraph 1 provides that a Contracting State of which a person is a resident has the sole right to tax items of income, wherever arising, if such income is not dealt with in the prior Articles of the Convention. If such income arises in the other Contracting State, however, it may also be taxed in that State. The determination of where income arises for this purpose is made under the domestic laws of the respective Contracting States unless the Convention specifies where the income arises (e.g., paragraph 6 of Article XI (Interest)) for purposes of determining the right to tax, in which case the provisions of the Convention control.

Paragraph 2 provides that to the extent that income distributed by an estate or trust resident in one Contracting State is deemed under the domestic law of that State to be a separate type of income "arising" within that State, such income distributed to a beneficiary resident in the other Contracting State may be taxed in the State of source at a maximum rate of 15 percent of the gross amount of such distribution. Such a distribution will, however, be exempt from tax in the State of source to the extent that the income distributed by the estate or trust was derived by the estate or trust from sources outside that State. Thus, in a case where the law of Canada treats a distribution made by a trust resident in Canada as a separate type of income arising in Canada, Canadian tax is limited by paragraph 2 to 15 percent of the gross amount distributed to a U.S. resident beneficiary. Although the Code imposes tax on certain domestic trusts (e.g., accumulation trusts) and such trusts are residents of the United States for purposes of Article IV (Residence) and paragraph 2 of Article XXII, paragraph 2 does not apply to distributions by such trusts because, pursuant to Code sections 667(e) and 662(b), these distributions have the same character in the hands of a nonresident beneficiary as they do in the hands of the trust. Thus, a distribution by a domestic accumulation trust is not a separate type of income for U.S. purposes. The taxation of such a distribution in the United States is governed by the distribution's character, the provisions of the Code and the provisions of the Convention other than the provision in paragraph 2 limiting the tax at source to 15 percent.

Article XXIII. CAPITAL

Although neither Canada nor the United States currently has national taxes on capital, Article XXIII provides rules for the eventuality that such taxes might be enacted in the future. Paragraph 1 provides that capital represented by real property (as defined in paragraph 2 of Article VI (Income From Real Property)) owned by a resident of a Contracting State and situated in the other Contracting State may be taxed in that other State.

Paragraph 2 provides that capital represented by either personal property forming part of the business property of a permanent establishment or personal property pertaining to a fixed base in a Contracting State may be taxed in that State.

Paragraph 3 provides that capital represented by ships and aircraft operated by a resident of a Contracting State in international traffic and by personal property pertaining to the operation of such ships and aircraft are taxable only in the Contracting State of residence.

Paragraph 4 provides that all elements of capital other than those covered by paragraphs 1, 2, and 3 are taxable only in the Contracting State of residence. Thus, capital represented by motor vehicles or railway cars, not pertaining to a permanent establishment or fixed base in a Contracting State, would be taxable only in the Contracting State of which the taxpayer is a resident.

Article XXIV. ELIMINATION OF DOUBLE TAXATION

Paragraph 1 provides the general rules that will apply under the Convention with respect to foreign tax credits for Canadian taxes paid or accrued. The United States undertakes to allow to a citizen or resident of the United States, or to a company electing under Code section 1504(d) to be treated as a domestic corporation, a credit against the Federal income taxes imposed by the Code for the appropriate amount of income tax paid or accrued to Canada. In the case of a company which is a resident of the United States owning 10 percent or more of the voting stock of a company which is a resident of Canada (which for this purpose does not include a company electing under Code section 1504(d) to be treated as a domestic corporation), and from which it receives dividends in a taxable year, the United States shall allow as a credit against income taxes imposed by the Code the appropriate amount of income tax paid or accrued to Canada by the Canadian company with respect to the profits out of which such company paid the dividends.

The direct and deemed-paid credits allowed by paragraph 1 are subject to the limitations of the Code as they may be amended from time to time without changing the general principle of paragraph 1. Thus, as is generally the case under U.S. income tax conventions, provisions such as Code sections 901(c), 904, 905, 907, 908, and 911 apply for purposes of computing the allowable credit under paragraph 1.

The term "income tax paid or accrued" is defined in paragraph 7 of Article XXIV to include certain specified taxes which are paid or accrued. Paragraph 1 provides a credit for these specified taxes whether or not they qualify as creditable under Code section 901 or 903. However, if any portion of the Canadian taxes creditable under the Convention does not qualify as income taxes or "in lieu" taxes under the Code, the amount of direct and deemed-paid credit that may be claimed under the Convention may not exceed the proportion of the Federal income taxes imposed by the Code that the taxpayer's taxable income arising in Canada bears to the taxpayer's worldwide taxable income. In other words, Canadian taxes made creditable solely by paragraph 1 are creditable only to the extent of a per country limitation computed with respect to Canada pursuant to the special source rules set forth in paragraphs 3 and 6, subject to U.S. limitation rules (e.g., Code sections 904(b)(2) and 904(f)). If, after application of these rules, a person has paid or accrued an amount to Canada in excess of the amount creditable against U.S. tax for a given year, the excess may be carried over to other years to offset U.S. tax on income arising in Canada under the Convention.

A taxpayer may, for any year, claim a credit pursuant to the rules of the Code. In such case, the taxpayer would be subject to the limitations established in the Code. In addition, any Canadian taxes covered by paragraph 1 which are not creditable under the Code would not be credited.

The Convention only provides a credit for amounts paid or accrued. The determination of whether an amount is paid or accrued is made under the Code.

The general rule for avoiding double taxation in Canada is provided in paragraph 2. Pursuant to paragraph 2(a) Canada undertakes to allow to a resident of Canada a credit against income taxes imposed under the Income Tax Act for the appropriate amount of income taxes paid or accrued to the United States. Paragraph 2(b) provides for the deduction by a Canadian company, in computing taxable income, of any dividend received out of the exempt surplus of a U.S. company which is an affiliate. The provisions of paragraph 2 are subject to the provisions of the Income Tax Act as they may be amended from time to time without changing the general principle of paragraph 2.

Paragraph 3 provides source rules for purposes of applying Article XXIV. Profits, income, or gains of a resident of a Contracting State which may be taxed in the other Contracting State in accordance with the Convention, for reasons other than the saving clause of paragraph 2 of Article XXIX (Miscellaneous Rules) (e.g., pensions and annuities taxable where arising pursuant to Article XVIII (Pensions and Annuities)), are deemed to arise in the latter State. This rule does not, however, apply to gains taxable under paragraph 5 of Article XIII (Gains) (i.e., gains taxed by a Contracting State derived from the alienation of property by a former resident of that State). Gains from such an alienation arise, pursuant to paragraph 3(b), in the State of which the alienator is a resident. Thus, if in accordance with paragraph 5 of Article XIII, Canada imposes tax on certain gains of a U.S. resident such gains are deemed, pursuant to paragraphs 2 and 3(b) of Article XXIV, to arise in the United States for purposes of computing the deduction against Canadian tax for the U.S. tax on such gain. Under the Convention such gains arise in the United States for purposes of the United States foreign tax credit. Paragraph 3(b) also provides that profits, income, or gains arise in the Contracting State of which a person is a resident if they may not be taxed in the other Contracting State under the provisions of the Convention (e.g., alimony), other than the "saving clause" of paragraph 2 of Article XXIX.

The rules of paragraph 1 are modified in certain respects by rules in paragraphs 4 and 5 for income derived by United States citizens who are residents of Canada. Paragraph 4 provides two steps for the elimination of double taxation in such a case. First, paragraph 4(a) provides that Canada shall allow a deduction from (credit against) Canadian tax in respect of income tax paid or accrued to the United States in respect of profits, income, or gains which arise in the United States (within the meaning of paragraph 3(a)); the deduction against Canadian tax need not, however, exceed the amount of income tax that would be paid or accrued to the United States if the individual were not a U.S. citizen, after taking into account any relief available under the Convention.

The second step, as provided in paragraph 4(b), is that the United States allows as a credit against United States tax, subject to the rules of paragraph 1, the income tax paid or accrued to Canada after the Canadian credit for U.S. tax provided by paragraph 4(a). The credit so allowed by the United States is not to reduce the portion of the United States tax that is creditable against Canadian tax in accordance with paragraph 4(a).

The following example illustrates the application of paragraph 4.

Example A

- A U.S. citizen who is a resident of Canada earns $175 of income from the performance of independent personal services, of which $100 is derived from services performed in Canada and $75 from services performed in the United States. That is his total world-wide income.
- If he were not a U.S. citizen, the United States could tax $75 of that amount under Article XIV (Independent Personal Services). By reason of paragraph 3(a), the $75 that may be taxed by the United States under Article XIV is deemed to arise in the United States. Assume that the U.S. tax on the $75 is $25.
- However, since the individual is a U.S. citizen, he is subject to U.S. tax on his worldwide income of $175. After excluding $75 under section 911, his taxable income is $100 and his U.S. tax is $40.
- Because he is a resident of Canada, he is also subject to Canadian tax on his worldwide income. Assume that Canada taxes the $175 at $75.
- Canada will credit against its tax of $75 the U.S. tax at source of $25, leaving a net Canadian tax of $50.
- The United States will credit against its tax of $40 the Canadian tax net of credit, but without reducing its source basis tax of $25; thus, the allowable credit is $40 - $25 = $15.
- To use a credit of $15 requires Canadian source taxable income of $37.50 ($37.50/$100 x $40 = $15). Without any special treaty rule, Canadian source taxable income would be only $25 ($100 less the section 911 exclusion of $75). Paragraph 6 provides for resourcing an additional $12.50 of income to Canada, so that the credit of $15 can be fully used.

Paragraph 5 provides special rules for the elimination of double taxation in the case of dividends, interest, and royalties earned by a U.S. citizen resident in Canada. These rules apply notwithstanding the provisions of paragraph 4, but only as long as the law in Canada allows a deduction in computing income for the portion of any foreign tax paid in respect of dividends, interest, or royalties which exceeds 15 percent of the amount of such items of income and only with respect to those items of income. The rules of paragraph 4 apply with respect to other items of income; moreover, if the law in force in Canada regarding the deduction for foreign taxes changes, the provisions of paragraph 5 shall not apply and the U.S. foreign tax credit for Canadian taxes and the Canadian credit for U.S. taxes will be determined solely pursuant to the provisions of paragraph 4.

The calculations under paragraph 5 are as follows. First, the deduction allowed in Canada in computing income shall be made with respect to U.S. tax on the dividends, interest, and royalties before any foreign tax credit by the United States with respect to income tax paid or accrued to Canada. Second, Canada shall allow a deduction from (credit against) Canadian tax for U.S. tax paid or accrued with respect to the dividends, interest, and royalties, but such credit need not exceed 15 percent of the gross amount of such items of income that have been included in computing income for Canadian tax purposes. (The credit may, however, exceed the amount of tax that the United States would be entitled to levy under the Convention upon a Canadian resident who is not a U.S. citizen.) Third, for purposes of computing the U.S. tax on such dividends, interest, and royalties, the United States shall allow as a credit against the U.S. tax the income tax paid or accrued to Canada after the 15 percent credit against Canadian tax for income tax paid or accrued to the United States. The United States is in no event obliged to give a credit for Canadian income tax which will reduce the U.S. tax below 15 percent of the amount of the dividends, interest, and royalties.

The rules of paragraph 5 are illustrated by the following simplified example.

Example B

-- A U.S. citizen who is a resident of Canada has $100 of royalty income arising in the United States. The tentative U.S. tax before foreign tax credit is $40.

-- Canada, under its law, allows a deduction for the U.S. tax in excess of 15 percent or, in this case, a deduction of $25 ($40 - $15). The Canadian taxable income is $75 and the Canadian tax on that amount is $35.

-- Canada gives a credit of $15 (the maximum credit allowed is 15 percent of the gross royalty taken into Canadian income) and collects a net tax of $20.

-- The United States allows a credit for the net Canadian tax against its tax in excess of 15 percent. Thus, the maximum credit is $25 ($40 - $15). But since the net Canadian tax paid was $20, the usable credit is $20.

-- To be able to use a credit of $20 requires Canadian source taxable income of $50 (50% of the U.S tentative tax of $40). Under paragraph 6, $50 of the U.S. royalty is resourced to be of Canadian source. The credit of $20 may then be offset against the U.S. tax of $40, leaving a net U.S. tax of $20.

-- The combined tax paid to both countries is $40, $20 to Canada and $20 to the United States.

Paragraph 6 is necessary to implement the objectives of paragraphs 4(b) and 5(c). Paragraph 6 provides that where a U.S. citizen is a resident of Canada, items of income referred to in paragraph 4 or 5 are deemed for the purposes of Article XXIV to arise in Canada to the extent necessary to avoid double taxation of income by Canada and the United States consistent with the objectives of paragraphs 4(b) and 5(c). Paragraph 6 can override the source rules of paragraph 3 to permit a limited resourcing of income. The principles of paragraph 6 have effect, pursuant to paragraph 3(b) of Article XXX (Entry Into Force), for taxable years beginning on or after January 1, 1976. See the discussion of Article XXX below.

Paragraph 7 provides that any reference to "income tax paid or accrued" to Canada or the United States includes Canadian tax or United States tax, as the case may be. The terms "Canadian tax" and "United States tax" are defined in paragraphs 1(c) and 1(d) of Article III (General Definitions). References to income taxes paid or accrued also include taxes of general application paid or accrued to a political subdivision or local authority of Canada or the United States which are not imposed by such political subdivision or local authority in a manner inconsistent with the provisions of the Convention and which are substantially similar to taxes of Canada or the United States referred to in paragraphs 2 and 3(a) of Article II (Taxes Covered).

In order for a tax imposed by a political subdivision or local authority to fall within the scope of paragraph 7, such tax must apply to individuals, companies, or other persons generally, and not only to a particular class of individuals or companies or a particular type of business. The tax must also be substantially similar to the national taxes referred to in paragraphs 2 and 3(a) of Article II. Finally, the political subdivision or local authority must apply its tax in a manner not inconsistent with the provisions of the Convention. For example, the political subdivision or local authority must not impose its tax on a resident of the other Contracting State earning business profits within the political subdivision or local authority but not having a permanent establishment there.

Paragraph 8 relates to the provisions of Article XXIII (Capital). It provides that where a resident of a Contracting State owns capital which, in accordance with the provisions of Article XXIII, may be taxed in the other Contracting State, the State of residence shall allow as a deduction from (credit against) its tax on capital an amount equal to the capital tax paid in the other Contracting State. The deduction is not, however, to exceed that part of the capital tax, computed before the deduction, which is attributable to capital which may be taxed in the other State.

Article XXV. NON-DISCRIMINATION

Paragraphs 1 and 2 of Article XXV protect individual citizens of a Contracting State from discrimination by the other Contracting State in taxation matters. Paragraph 1 provides that a citizen of a Contracting State who is a resident of the other Contracting State may not be subjected in that other State to any taxation or requirement connected with taxation which is other or more burdensome than the taxation and connected requirements imposed on similarly situated citizens of the other State.

Paragraph 2 assures protection in a case where a citizen of a Contracting State is not a resident of the other Contracting State. Such a citizen may not be subjected in the other State to any taxation or requirement connected to taxation which is other or more burdensome than the taxation and connected requirements to which similarly situated citizens of any third State are subjected. The reference to citizens of a third State "in the same circumstances" includes consideration of the State of residence. Thus, pursuant to paragraph 2, the Canadian taxation with respect to a citizen of the United States resident in, for example, the United Kingdom may not be more burdensome than the taxation of a U.K. citizen resident in the United Kingdom. Any benefits available to the U.K. citizen by virtue of an income tax convention between the United Kingdom and Canada would be available to the U.S. citizen resident in the United Kingdom if he is otherwise in the same circumstances as the U.K. citizen.

Paragraph 3 assures that, in computing taxable income, an individual resident of a Contracting State will be entitled to the same deduction for dependents resident in the other Contracting State that would be allowed if the dependents were residents of the individual's State of residence. The term "dependent" is defined in accordance with the rules set forth in paragraph 2 of Article III (General Definitions). For U.S. tax purposes, paragraph 3 does not expand the benefits currently available to a resident of the United States with a dependent resident in Canada. See Code section 152(b)(3).

Paragraph 4 allows a resident of Canada (not a citizen of the United States) to file a joint return in cases where such person earns salary, wages, or other similar remuneration as an employee and such income is taxable in the United States under the Convention. Paragraph 4 does not apply where the resident of Canada earns wages which are exempt in the United States under Article XV (Dependent Personal Services) or earns only income taxable by the United States under provisions of the Convention other than Article XV.

The benefit provided by paragraph 4 is available regardless of the residence of the taxpayer's spouse. It is limited, however, by a formula designed to ensure that the benefit is available solely with respect to persons whose U.S. source income is entirely, or almost entirely, wage income. The formula limits the United States tax with respect to wage income to that portion of the total U.S. tax that would be payable for the taxable year if both the individual and his spouse were United States citizens as the individual's taxable income (determined without any of the benefits made available by paragraph 4, such as the standard deduction) bears to the total taxable income of the individual and his spouse. The term "total United States tax" used in the formula is total United States tax without regard to any foreign tax credits, as provided in subparagraph 4(a). (Foreign income taxes may, however, be claimed as deductions in computing taxable income, to the extent allowed by the Code.) In determining total taxable income of the individual and his spouse, the benefits made available by paragraph 4 are taken into account, but a deficit of the spouse is not.

The following example illustrates the application of paragraph 4.

> A, a Canadian citizen and resident, is married to B who is also a Canadian citizen and resident. A earns \$12,000 of wages taxable in the U.S. under Article XV (Dependent Personal Services) and \$2,000 of wages taxable only in Canada. B earns \$1,000 of U.S. source dividend income, taxed by the United States at 15 percent pursuant to Article X (Dividends). B also earns \$2,000 of wages taxable only in Canada. A's taxable income for U.S. purposes, determined without regard to paragraph 4, is \$11,700 (\$12,000 - \$2,000 (Code sections 151(b) and 873(b)(3)) + \$1,700 (Code section 63)). The U.S. tax (Code section 1(d)) with respect to such income is \$2,084.50. The total U.S. tax payable by A and B if both were U.S. citizens and all their income arose in the United States would be \$2,013 under Code section 1(a) on taxable income of \$14,800 (\$17,000 - \$200 (Code section 116) - \$2,000 (Code section 151)). Pursuant to paragraph 4, the U.S. tax imposed on A's wages from U.S. sources is limited to \$1,591.36 $\left(\frac{\$11{,}700}{\$14{,}800} \times \$2{,}013\right)$. B's U.S. tax liability with respect to the U.S. source dividends remains \$150.

The provisions of paragraph 4 may be elected on a year-by-year basis. They are purely computational and do not make either or both spouses residents of the United States for the purpose of other U.S. income tax conventions.

Paragraph 5 protects against discrimination in a case where the capital of a company which is a resident of one Contracting State is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State. Such a company shall not be subjected in the State of which it is a resident to any taxation or requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which are subjected other similar companies which are residents of that State but whose capital is wholly or partly owned or controlled, directly or indirectly, by one or more residents of a third State.

Paragraph 6 protects against discrimination in the case of a permanent establishment which a resident of one Contracting State has in the other Contracting State. The taxation of such a permanent establishment by the other Contracting State shall not be less favorable than the taxation of residents of that other State carrying on the same activities. The paragraph specifically overrides the provisions of Article XXIV (Elimination of Double Taxation), thus ensuring that permanent establishments will be entitled to relief from double taxation on a basis comparable to the relief afforded to similarly situated residents. Paragraph 6 does not oblige a Contracting State to grant to a resident of the other Contracting State any personal allowances, reliefs, and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents. The principles of paragraph 6 would apply with respect to a fixed base as well as a permanent establishment. Paragraph 6 does not, however, override the provisions of Code section 906.

Paragraph 7 concerns the right of a resident of a Contracting State to claim deductions for purposes of computing taxable profits in the case of disbursements made to a resident of the other Contracting State. Such disbursements shall be deductible under the same conditions as if they had been made to a resident of the first-mentioned State. These provisions do not apply to amounts to which paragraph 1 of Article IX (Related Persons), paragraph 7 of Article XI (Interest), or paragraph 7 of Article XII (Royalties) apply. Paragraph 7 of Article XXV also provides that, for purposes of determining the taxable capital of a resident of a Contracting State, any debts of such person to a resident of the other Contracting State shall be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State. This portion of paragraph 7 relates to Article XXIII (Capital).

Paragraph 8 provides that, notwithstanding the provisions of paragraph 7, a Contracting State may enforce the provisions of its taxation laws relating to the deductibility of interest, in force on September 26, 1980, or as modified subsequent to that date in a manner that does not change the general nature of the provisions in force on September 26, 1980; or which are adopted after September 26, 1980, and are designed to ensure that nonresidents do not enjoy a more favorable tax treatment under the taxation laws of that State than that enjoyed by residents. Thus Canada may continue to limit the deductions for interest paid to certain nonresidents as provided in section 18(4) of Part I of the Income Tax Act.

Paragraph 9 provides that expenses incurred by citizens or residents of a Contracting State with respect to any convention, including any seminar, meeting, congress, or other function of similar nature, held in the other Contracting State, are deductible for purposes of taxation in the first-mentioned State to the same extent that such expenses would be deductible if the convention were held in that first-mentioned State. Thus, for U.S. income tax purposes an individual who is a citizen or resident of the United States and who attends a convention held in Canada may claim deductions for expenses incurred in connection with such convention without regard to the provisions of Code section 274(h). Section 274(h) imposes special restrictions on the deductibility of expenses incurred in connection with foreign conventions. A claim for a deduction for such an expense remains subject, in all events, to the provisions of U.S. law with respect to the deductibility of convention expenses generally (e.g., Code sections 162 and 212). Similarly, in the case of a citizen or resident of Canada attending a convention in the United States, paragraph 9 requires Canada to allow a deduction for expenses relating to such convention as if the convention had taken place in Canada.

Paragraph 10 provides that, notwithstanding the provisions of Article II (Taxes Covered), the provisions of Article XXV apply in the case of Canada to all taxes imposed under the Income Tax Act; and, in the case of the United States, to all taxes imposed under the Code. Article XXV does not apply to taxes imposed by political subdivisions or local authorities of Canada or the United States.

Article XXV substantially broadens the protection against discrimination provided by the 1942 Convention, which contains only one provision dealing specifically with this subject. That provision, paragraph 11 of the Protocol to the 1942 Convention, states that citizens of one of the Contracting States residing within the other Contracting State are not to be subjected to the payment of more burdensome taxes than the citizens of the other State.

The benefits of Article XXV may affect the tax liability of a U.S. citizen or resident with respect to the United States. See paragraphs 2 and 3 of Article XXIX (Miscellaneous Rules).

Article XXVI. MUTUAL AGREEMENT PROCEDURE

Paragraph 1 provides that where a person considers that the actions of one or both of the Contracting States will result in taxation not in accordance with the Convention, he may present his case in writing to the competent authority of the Contracting State of which he is a resident or, if he is a resident of neither Contracting State, of which he is a national. Thus, a resident of Canada must present to the Minister of National Revenue (or his authorized representative) any claim that such resident is being subjected to taxation contrary to the Convention. A person who requests assistance from the competent authority may also avail himself of any remedies available under domestic laws.

Paragraph 2 provides that the competent authority of the Contracting State to which the case is presented shall endeavor to resolve the case by mutual agreement with the competent authority of the other Contracting State, unless he believes that the objection is not justified or he is able to arrive at a satisfactory unilateral solution. Any agreement reached between the competent authorities of Canada and the United States shall be implemented notwithstanding any time or other procedural limitations in the domestic laws of the Contracting States, except where the special mutual agreement provisions of Article IX (Related Persons) apply, provided that the competent authority of the Contracting State asked to waive its domestic time or procedural limitations has received written notification that such a case exists within six years from the end of the taxable year in the first-mentioned State to which the case relates. The notification may be given by the competent authority of the first-mentioned State, the taxpayer who has requested the competent authority to take action, or a person related to the taxpayer. Unlike Article IX, Article XXVI does not require the competent authority of a Contracting State to grant unilateral relief to avoid double taxation in a case where timely notification is not given to the competent authority of the other Contracting State. Such unilateral relief may, however, be granted by the competent authority in its discretion pursuant to the provisions of Article XXVI and in order to achieve the purposes of the Convention. In a case where the provisions of Article IX apply, the provisions of paragraphs 3, 4, and 5 of that Article are controlling with respect to adjustments and corresponding adjustments of income, loss, or tax and the effect of the Convention upon time or procedural limitations of domestic law. Thus, if relief is not available under Article IX because of fraud, the provisions of paragraph 2 of Article XXVI do not independently authorize such relief.

Paragraph 3 provides that the competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. In particular, the competent authorities may agree to the same attribution of profits to a resident of a Contracting State and its permanent establishment in the other Contracting State; the same allocation of income, deductions, credits, or allowances between persons; the same determination of the source of income; the same characterization of particular items of income; a common meaning of any term used in the Convention; rules, guidelines, or procedures for the elimination of double taxation with respect to income distributed by an estate or trust, or with respect to a partnership; or to increase any dollar amounts referred to in the Convention to reflect monetary or economic developments. The competent authorities may also consult and reach agreements on rules, guidelines, or procedures for the elimination of double taxation in cases not provided for in the Convention.

The list of subjects of potential mutual agreement in paragraph 3 is not exhaustive; it merely illustrates the principles set forth in the paragraph. As in the case of other U.S. tax conventions, agreement can be arrived at in the context of determining the tax liability of a specific person or in establishing rules, guidelines, and procedures that will apply generally under the Convention to resolve issues for classes of taxpayers. It is contemplated that paragraph 3 could be utilized by the competent authorities, for example, to resolve conflicts between the domestic laws of Canada and the United States with respect to the allocation and apportionment of deductions.

Paragraph 4 provides that each Contracting State will endeavor to collect on behalf of the other State such amounts as may be necessary to ensure that relief granted by the Convention from taxation imposed by the other State does not enure to the benefit of persons not entitled to such relief. Paragraph 4 does not oblige either Contracting State to carry out administrative measures of a different nature from those that would be used by Canada or the United States in the collection of its own tax or which would be contrary to its public policy.

Paragraph 5 confirms that the competent authorities of Canada and the United States may communicate with each other directly for the purpose of reaching agreement in the sense of paragraphs 1 through 4.

Article XXVII. EXCHANGE OF INFORMATION

Paragraph 1 authorizes the competent authorities to exchange the information necessary for carrying out the provisions of the Convention or the domestic laws of Canada and the United States concerning taxes covered by the Convention, insofar as the taxation under those domestic laws is not contrary to the Convention. The authority to exchange information granted by paragraph 1 is not restricted by Article I (Personal Scope), and thus need not relate solely to persons otherwise covered by the Convention. It is contemplated that Article XXVII will be utilized by the competent authorities to exchange information upon request, routinely, and spontaneously.

Any information received by a Contracting State pursuant to the Convention is to be treated as secret in the same manner as information obtained under the taxation laws of that State. Such information shall be disclosed only to persons or authorities, including courts and administrative bodies, involved in the assessment or collection of, the administration and enforcement in respect of, or the determination of appeals in relation to the taxes covered by the Convention, and the information may be used by such persons only for such purposes. (In accordance with paragraph 4, for the purposes of this Article the Convention applies to a broader range of taxes than those covered specifically by Article II (Taxes Covered).)

In specific cases a competent authority providing information may, pursuant to paragraph 3, impose such other conditions on the use of information as are necessary. Although the information received by persons described in paragraph 1 is to be treated as secret, it may be disclosed by such persons in public court proceedings or in judicial decisions.

The provisions of paragraph 1 authorize the U.S. competent authority to continue to allow the General Accounting Office to examine tax return information received from Canada when GAO is engaged in a study of the administration of U.S. tax laws pursuant to a directive of Congress. However, the secrecy requirements of paragraph 1 must be met.

If a Contracting State requests information in accordance with Article XXVII, the other Contracting State shall endeavor, pursuant to paragraph 2, to obtain the information to which the request relates in the same manner as if its own taxation were involved, notwithstanding the fact that such State does not need the information. In addition, the competent authority requested to obtain information shall endeavor to provide the information in the particular form requested, such as depositions of witnesses and copies of unedited original documents, to the same extent such depositions and documents can be obtained under the laws or administrative practices of that State with respect to its own taxes.

Paragraph 3 provides that the provisions of paragraphs 1 and 2 do not impose on Canada or the United States the obligation to carry out administrative measures at variance with the laws and administrative practice of either State; to supply information which is not obtainable under the laws or in the normal course of the administration of either State; or to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy. Thus, Article XXVII allows, but does not obligate, the United States and Canada to obtain and provide information that would not be available to the requesting State under its laws or administrative practice or that in different circumstances would not be available to the State requested to provide the information. Further, Article XXVII allows a Contracting State to obtain information for the other Contracting State even if there is no tax liability in the State requested to obtain the information. Thus, the United States will continue to be able to give Canada tax information even if there is no U.S. tax liability at issue.

Paragraph 4 provides that, for the purposes of Article XXVII, the Convention applies, in the case of Canada, to all taxes imposed by the Government of Canada on estates and gifts and under the Income Tax Act and, in the case of the United States, to all taxes imposed under the Internal Revenue Code. Article XXVII does not apply to taxes imposed by political subdivisions or local authorities of the Contracting States. Paragraph 4 is designed to ensure that information exchange will extend to most national level taxes on both sides, and specifically to information gathered for purposes of Canada's taxes on estates and gifts (not effective for deaths or gifts after 1971). This provision is intended to mesh with paragraph 8 of Article XXX (Entry Into Force), which terminates the existing estate tax convention between the United States and Canada.

Article XXVIII. DIPLOMATIC AGENTS AND CONSULAR OFFICERS

Article XXVIII states that nothing in the Convention affects the fiscal privileges of diplomatic agents or consular officers under the general rules of international law or under the provisions of special agreements. However, various provisions of the Convention could apply to such persons, such as those concerning exchange of information, mutual agreement, and non-discrimination.

Article XXIX. MISCELLANEOUS RULES

Paragraph 1 states that the provisions of the Convention do not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance accorded by the laws of a Contracting State in the determination of the tax imposed by that State. Thus, if a deduction would be allowed for an item in computing the taxable income of a Canadian resident under the Code, such deduction is available to such person in computing taxable income under the Convention. Paragraph 1 does not, however, authorize a taxpayer to make inconsistent choices between rules of the Code and rules of the Convention. For example, if a resident of Canada desires to claim the benefits of the "attributable to" rule of paragraphs 1 and 7 of Article VII (Business Profits) with respect to the taxation of business profits of a permanent establishment, such person must use the "attributable to" concept consistently for all items of income and deductions and may not rely upon the "effectively connected" rules of the Code to avoid U.S. tax on other items of attributable income. In no event are the rules of the Convention to increase overall U.S. tax liability from what liability would be if there were no convention.

Paragraph 2 provides a "saving clause" pursuant to which Canada and the United States may each tax its residents, as determined under Article IV (Residence), and the United States may tax its citizens (including any former citizen who lost his citizenship for the principal purpose of avoiding of U.S. income tax, but only for a period of 10 years following such loss) and companies electing under Code section 1504(d) to be treated as domestic corporations, as if there were no convention between the United States and Canada with respect to taxes on income and capital.

Paragraph 3 provides that, notwithstanding paragraph 2, the United States and Canada must respect certain specified provisions of the Convention in regard to residents, citizens, and section 1504(d) companies. Paragraph 3(a) lists certain paragraphs and Articles of the Convention that represent exceptions to the "saving clause" in all situations; paragraph 3(b) provides a limited further exception for students who have not acquired immigrant status in the State where they are temporarily present.

Paragraph 4 provides relief with respect to social security taxes imposed on employers, employees, and self-employed persons under Code sections 1401, 3101, and 3111. Income from personal services not subject to tax by the United States under the provisions of the 1942 Convention is not to be considered wages or net earnings from self-employment for purposes of the U.S. social security taxes with respect to taxable years of the taxpayer not barred by the statute of limitations (under the Code) ending on or before December 31 of the year in which instruments of ratification are exchanged. Thus, if instruments of ratification are exchanged in 1981 a resident of Canada earning income from personal services and such person's employer may apply for refunds of the employee's and employer's shares of U.S. social security tax paid attributable to the employee's income from personal services that is exempt from U.S. tax by virtue of the 1942 Convention. In this example, the refunds would be available for social security taxes paid with respect to taxable years not barred by the statute of limitations of the Code ending on or before December 31, 1981. For purposes of Code section 6611, the date of overpayment with respect to refunds of U.S. tax pursuant to paragraph 4 is the date on which instruments of ratification of the Convention are exchanged.

Under certain limited circumstances, an employee may, pursuant to paragraph 5 of Article XXX (Entry Into Force), claim an exemption from U.S. tax on wages under the 1942 Convention for one year after the Convention comes into force. The provisions of paragraph 4 would not, however, provide an exemption from U.S. social security taxes for such year.

Paragraph 4 does not modify existing U.S. statutes concerning social security benefits or funding. The Social Security Act requires the general funds of the Treasury to reimburse the social security trust funds on the basis of the records of wages and self-employment income maintained by the Social Security Administration. The Convention does not alter those records. Thus, any refunds of tax made pursuant to paragraph 4 would not affect claims for U.S. quarters of coverage with respect to social security benefits. And such refunds would be charged to general revenue funds, not social security trust funds.

Paragraph 5 provides a method to resolve conflicts between the Canadian and U.S. treatment of individual retirement accounts. Certain Canadian retirement plans which are qualified plans for Canadian tax purposes do not meet Code requirements for qualification. As a result, the earnings of such a plan are currently included in income, for U.S. tax purposes, rather than being deferred until actual distributions are made by the plan. Canada defers current taxes on the earnings of such a plan but imposes tax on actual distributions from the plan. Paragraph 5 is designed to avoid a mismatch of U.S. taxable income and foreign tax credits attributable to the Canadian tax on such distributions. Under the paragraph a United States citizen who is a resident of Canada and a beneficiary of a Canadian registered retirement savings plan may elect to defer U.S. taxation with respect to any income accrued in the plan but not distributed by the plan, until such time as a distribution is made from the plan or any substitute plan. The election is to be made under rules established by the competent authority of the United States.

Paragraph 6 provides that if 25 percent or more of the capital of a company which is a resident of a Contracting State is owned directly or indirectly by individuals who are not residents of that State, and if by reason of special measures the tax imposed in that State on that company with respect to dividends (other than direct investment dividends referred to in paragraph 2(a) of Article X (Dividends)), interest, or royalties arising in the other Contracting State is substantially less than the tax generally imposed by the first-mentioned State on corporate business profits, then, nothwithstanding the provisions of Article X, XI (Interest), or XII (Royalties), the other State may tax such dividends, interest, or royalties as if there were no convention between the United States and Canada with respect to taxes on income and on capital. Thus, the Contracting State in which dividends, interest, or royalties arise may substitute its domestic law rate of tax on such income, which in the United States is currently 30 percent and in Canada is currently 25 percent, for the maximum rates provided for in the Convention, which range from zero to 15 percent.

The phrase "substantially less than" is subject to definition pursuant to paragraph 2 of Article III (General Definitions). In any event, the phrase does not include the situation under Canadian law where a privately owned company distributes its investment income in the form of dividends and receives a refund of up to 16-2/3 percent of such a distribution. The effect of such a refund is not considered to produce tax "substantially less than" the tax generally imposed in Canada.

Article XXX. ENTRY INTO FORCE

Paragraph 1 provides that the Convention is subject to ratification in accordance with the procedures of Canada and the United States. The exchange of instruments of ratification is to take place at Ottawa as soon as possible.

Paragraph 2 provides, subject to paragraph 3, that the Convention shall enter into force upon the exchange of instruments of ratification. It has effect, with respect to source State taxation of dividends, interest, royalties, pensions, annuities, alimony, and child support, for amounts paid or credited on or after the first day of the second calendar month after the date on which the instruments of ratification are exchanged. For other taxes, the Convention takes effect for taxable years beginning on or after January 1 next following the date when instruments of ratification are exchanged. In the case of relief from United States social security taxes provided by paragraph 4 of Article XXIX (Miscellaneous Rules), the Convention also has effect for taxable years before the date on which instruments of ratification are exchanged.

Paragraph 3 provides special effective date rules for foreign tax credit computations with respect to taxes paid or accrued to Canada. Paragraph 3(a) provides that the tax on 1971 undistributed income on hand imposed by Part IX of the

Income Tax Act of Canada is considered to be an "income tax" for distributions made on or after January 1, 1972 and before January 1, 1979. Any such tax which is paid or accrued under U.S. standards is considered to be imposed at the time of distribution and on the recipient of the distribution, in the proportion that the distribution out of undistributed income with respect to which the tax has been paid bears to 85 percent of such undistributed income. A person claiming a credit for tax pursuant to paragraph 3(a) is obligated to compute the amount of the credit in accordance with that paragraph.

Paragraph 3(b) provides that the principles of paragraph 6 of Article XXIV (Elimination of Double Taxation), which provides for resourcing of certain dividend, interest, and royalty income to eliminate double taxation of U.S. citizens residing in Canada, have effect for taxable years beginning on or after January 1, 1976. The paragraph is intended to grant the competent authorities sufficient flexibility to address certain practical problems that have arisen under the 1942 Convention. It is anticipated that the competent authorities will be guided by paragraphs 4 and 5 of Article XXIV in applying paragraph 3(b) of Article XXX. Any claim for refund based on the provisions of paragraph 3 may be filed on or before June 30 of the calendar year following the year in which instruments of ratification are exchanged, notwithstanding statutes of limitations or other rules of domestic law to the contrary. For purposes of Code section 6611, the date of overpayment is the date on which instruments of ratification are exchanged, with respect to any refunds of U.S. tax pursuant to paragraph 3.

Paragraph 4 provides that, subject to paragraph 5, the 1942 Convention ceases to have effect for taxes for which the Convention has effect under the provisions of paragraph 2. For example, if under paragraph 2 the Convention were to have effect with respect to taxes withheld at source on dividends paid as of March 1, 1981, the 1942 Convention will not have effect with respect to such taxes.

Paragraph 5 modifies the rule of paragraph 4 to allow all of the provisions of the 1942 Convention to continue to have effect for the period through the first taxable year with respect to which the provisions of the Convention would otherwise have effect under paragraph 2(b), if greater relief from tax is available under the 1942 Convention than under the Convention.

Paragraph 6 provides that the 1942 Convention terminates on the last of the dates on which it has effect in accordance with the provisions of paragraphs 4 and 5.

Paragraph 7 terminates the Exchange of Notes between the United States and Canada of August 2 and September 17, 1928 providing for relief from double taxation of shipping profits. The provisions of the Exchange of Notes no longer have effect for taxable years beginning on or after January 1 following the exchange of instruments of ratification of the Convention. The 1942 Convention, in Article V, had suspended the effectiveness of the Exchange of Notes.

Paragraph 8 terminates the Convention between Canada and the United States for the Avoidance of Double Taxation with Respect to Taxes on the Estates of Deceased Persons signed on February 17, 1961. The provisions of that Convention cease to have effect with respect to estates of persons deceased on or after January 1 of the year following the exchange of instruments of ratification of the Convention.

Article XXXI. TERMINATION

Paragraph 1 provides that the Convention shall remain in force until terminated by Canada or the United States.

Paragraph 2 provides that either Canada or the United States may terminate the Convention at any time after 5 years from the date on which instruments of ratification are exchanged, provided that notice of termination is given through diplomatic channels at least 6 months prior to the date on which the Convention is to terminate.

Paragraph 3 provides a special termination rule in situations where Canada or the United States changes its taxation laws and the other Contracting State believes that such change is significant enough to warrant modification of the Convention. In such a circumstance, the Canadian Ministry of Finance and the United States Department of the Treasury would consult with a view to resolving the matter. If the matter cannot be satisfactorily resolved, the Contracting State requesting an accommodation because of the change in the other Contracting State's taxation laws may terminate the Convention by giving the 6 months' prior notice required by paragraph 2, without regard to whether the Convention has been in force for 5 years.

Paragraph 4 provides that, in the event of termination, the Convention ceases to have effect for tax withheld at source under Articles X (Dividends), XI (Interest), XII (Royalties), and XVIII (Pensions and Annuities), and under paragraph 2 of Article XXII (Other Income), with respect to amounts paid or credited on or after the first day of January following the expiration of the 6 month period referred to in paragraph 2. In the case of other taxes, the Convention shall cease to have effect in the event of termination with respect to taxable years beginning on or after January 1 following the expiration of the 6 month period referred to in paragraph 2.

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TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE ARGENTINE REPUBLIC FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL

SIGNED ON MAY 7, 1981

This Convention was negotiated on the basis of the U.S. Model Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, published in May 1977, and the Model Double Taxation Convention on Income and Capital published by the Organization for Economic Cooperation and Development (OECD) in January 1977. However, it departs from those models in several respects to accommodate Argentina's position as a developing country which relies almost exclusively on source basis taxation. A protocol sets forth certain supplementary understandings on issues covered in the Convention.

The technical explanation is an official guide to the Convention (hereafter "the Treaty"). It reflects policies behind particular Treaty provisions, as well as understandings reached with respect to the interpretation and application of the Treaty.

Article 1. PERSONAL SCOPE

This Article identifies the persons who come within the scope of the Treaty and establishes the relationship between the Treaty and domestic law.

Paragraph 1 states that the Treaty generally applies to residents of one or both of the Contracting States. Certain provisions of the Treaty may apply to residents of third countries, for example Articles 9 (Associated Enterprises) and Article 26 (Exchange of Information and Administrative Assistance). The term "resident" is defined in Article 4 (Resident).

Paragraph 2 provides, in effect, that the Treaty may not increase tax above the liability that would result under domestic law or under other agreements between the Contracting States. For example, a Contracting State may not impose a tax authorized by the Treaty if its law does not impose a tax in such cases. And, if a deduction would be allowed for an item in computing the taxable income of an Argentine resident under the Internal Revenue Code ("Code"), such deduction is generally available to such person in computing taxable income under the Treaty.

Paragraph 1 does not, however, authorize a taxpayer to make inconsistent choices between rules of the Code and rules of the Treaty. In no event are the rules of the Treaty to increase overall U.S. tax liability above what liability would be if there were no treaty.

Paragraph 3 contains the traditional "saving clause" under which each Contracting State reserves the right to tax its residents, as defined in Article 4 (Resident), and its citizens as if the Treaty had not come into effect. The term "citizen" includes former citizens whose loss of citizenship had as a principal purpose the avoidance of income tax; in such a case the individual continues to be subject to the tax provisions of the country of former citizenship for a period of 10 years. The United States taxes the income of its citizens wherever resident, and in certain cases taxes former citizens in accordance with section 877 of the Code.

Paragraph 4 sets forth certain exceptions to the application of the saving clause where other provisions of the Treaty present overriding policies. These exceptions are necessary to make the Treaty work properly. For example, the saving clause does not affect the benefits provided under paragraphs 1(b) and 4 of Article 18 (Pensions, etc.). Thus, social security payments and other public pensions paid by Argentina are taxable only by Argentina even though the recipient may be a resident or citizen of the United States. Similarly, child support payments made by a resident of Argentina are taxable only in Argentina even though the recipient may be a resident of the United States. The benefits provided in Articles 23 (Relief from Double Taxation), 24 (Non-discrimination), and 25 (Mutual Agreement Procedure) are also available to residents and citizens of the Contracting States, notwithstanding the saving clause.

In some cases, the saving clause overrides benefits conferred by the Treaty on citizens or persons having immigrant status in a Contracting State, but does not override those benefits conferred on residents who are not citizens of, and do not have immigrant status in, that State. This second category of exceptions to the saving clause concerns the benefits provided under Article 19 (Government Service), Article 20 (Students and Trainees) and Article 27 (Diplomatic Agents and Consular Officers).

Article 2. TAXES COVERED

Paragraph 1 states that the Treaty applies to taxes on income and capital imposed at the national level by either of the Contracting States. Paragraph 1 is not intended either to broaden or limit paragraph 2.

Paragraph 2 enumerates the existing taxes to which the Treaty applies. In the United States these are the Federal income taxes imposed by the Internal Revenue Code and the excise tax imposed with respect to private foundations. The accumulated earnings tax (section 531 of the Code) and the personal holding company tax (section 541 of the Code) are not covered by the Treaty. The Treaty also does not cover the estate, gift, and generation skipping transfer taxes, the Windfall Profits Tax, Federal unemployment taxes, the excise taxes imposed on foreign insurance and reinsurance premiums under section 4371 or social security taxes.

The Argentine taxes covered by the Treaty are the tax on profits, the capital gains tax, the tax on capital of enterprises, and the tax on net worth. The tax on profits is in fact a broad tax on all Argentine source income except capital gains, which are taxed separately; in addition to business profits, it applies to employment and investment income, including withholding taxes on payments to nonresidents.

Paragraph 3 provides that the Treaty shall also apply to subsequently imposed taxes which are substantially similar to the existing taxes covered by the Treaty. The competent authorities agree to notify each other of substantial changes in their respective tax laws.

Paragraph 4 explains that for certain purposes the Treaty applies to taxes other than those covered in paragraphs 2 and 3 of this Article. For purposes of Article 24 (Non-discrimination), the Treaty applies to taxes of all kinds imposed at all levels of government. For purposes of Article 26 (Exchange of Information), the Treaty applies to taxes of every kind imposed at the national level. This expanded coverage is repeated in the respective articles.

Article 3. GENERAL DEFINITIONS

Paragraph 1 defines the principal terms used throughout the Treaty. Unless the context otherwise requires, the terms defined in this paragraph have a uniform meaning throughout the Treaty. It should be noted that a number of important terms are defined in other articles. For example, the term "resident" is defined in Article 4 (Resident), the term "permanent establishment" is defined in Article 5 (Permanent Establishment), and the terms "dividends" and "interest" are defined in Articles 10 (Dividends) and 11 (Interest), respectively.

The definitions of the terms "person", "company", and "enterprise of a Contracting State" are the same as the definitions in the U.S. Model. The term "international transport" includes all ship or air transport which is not solely between places in one of the Contracting States. The "competent authority" for the United States is the Secretary of the Treasury or his delegate, and for Argentina, the Ministry of Economy, Treasury, and Finance (Under Secretariat of Treasury).

The terms "United States" and "Argentina" include the continental shelf areas of the two countries. For the United States, the definition of the continental shelf is interpreted in accordance with section 638 of the Code and the regulations thereunder. The term "United States" does not include Puerto Rico, the Virgin Islands, Guam, or any other United States possession.

Paragraph 2 provides that terms not defined in the Treaty shall have the meaning which they have under the laws of the Contracting State concerning the taxes to which the Treaty applies, unless the context of the Treaty requires otherwise or unless the competent authorities agree on an acceptable definition under the terms of Article 25 (Mutual Agreement Procedure). The term "context" refers to the purpose and background of the provision in which the term appears. Pursuant to the provisions of Article 25, the competent authorities of the Contracting States may resolve any difficulties or doubts as to the interpretation or application of the Treaty. An agreement by the competent authorities with respect to the meaning of a term used in the Treaty would supersede conflicting meanings in the domestic laws of the Contracting States.

Article 4. RESIDENT

This Article sets forth rules for determining the residence of individuals, corporations, and other persons for purposes of the Treaty. A definition of residence is important because, except as otherwise provided in the Treaty, only a resident may claim the benefits of the Treaty.

Paragraph 1 of this Article enumerates several criteria by which a person may be considered a resident of a Contracting State under the laws of that State. A resident of the United States includes a resident alien or an alien present in the United States who elects to be treated as a resident under section 6013(g) or (h) of the Code.

An individual is not automatically a resident of the United States or Argentina for the purposes of the Treaty if he is a citizen of either State. To be a resident of a Contracting State for purposes of the Treaty, he must be subject to tax in that

State on account of his residence therein. Thus, an individual will be considered to be a U.S. resident if, without regard to his citizenship, he would be taxable by the United States on his worldwide income as a resident. Residence for this purpose is to be determined in accordance with the principles of Treasury regulations under section 871 of the Code.

In the case of a partnership, estate, or trust, paragraph 1 provides that residence applies only to the extent that the income derived by such entity is subject to tax on the basis of residence, either because the entity is taxed as a resident or to the extent that its partners or beneficiaries are taxed as residents. For example, for purposes of the Treaty, a U.S. partnership of which half the partners were U.S. residents and the other half were residents of Mexico would be considered one half resident in the United States. Argentina would have to apply the Treaty limitation in taxing half of the dividends paid from Argentina to that partnership.

Paragraph 2 provides a series of tie-breakers for assigning a single residence to a person who, under any of the criteria of paragraph 1, would be a resident of both countries pursuant to the laws of each of the countries. The tests, set forth in subparagraphs (a), (b), (c), and (d), are taken from the U.S. Model of May 1977.

The first test is where the individual has a permanent home. If this test is inconclusive because the individual has a permanent home in both countries or in neither of them, the second test is where his personal and economic relations are closer. If this test does not provide a satisfactory answer, the next test is where he has his habitual abode. If this test also fails to establish a single country of residence, because he has an habitual abode in both countries or in neither of them, the question turns to nationality, and if the individual is not a national of either State the competent authorities settle the question by mutual agreement.

Paragraph 3 provides that a company which under paragraph 1 is a resident of both Contracting States shall be considered a resident only of the Contracting State under the laws of which it is created or organized, whether at the national level or under the laws of a political subdivision. Thus, a corporation incorporated under the laws of a state of the United States is a resident only of the United States for purposes of the Treaty.

Paragraph 4 provides that, in the event that a person other than an individual or a company is a resident of both Contracting States under the provisions of paragraph 1, then the competent authorities of the two countries shall endeavor to resolve the question and to determine how the Treaty applies to such a person.

Paragraph 5 provides that nationals of either Contracting State performing governmental functions in the other Contracting State as employees of the Government or an instrumentality of the first State are considered to be residents of that first State if they continue to be taxed by that State on the same basis as residents are taxed. For example, a U.S. citizen employed by the U.S. Embassy in Buenos Aires will be treated as a U.S. resident and eligible for any Treaty benefits extended by Argentina to U.S. residents. The spouse and minor children residing with the employee who are also taxed on the same basis as U.S. residents would also be treated as U.S. residents for purposes of the Treaty. This provision is reciprocal.

Article 5. PERMANENT ESTABLISHMENT

Paragraph 1 defines in general terms the phrase "permanent establishment," which is relevant in particular, to the taxation of business profits.

Paragraph 2 gives some specific illustrations of the meaning of the term "permanent establishment." It includes an office, branch, factory, workshop or mine. It also includes facilities used for the purchase and export of goods. This is a special provision inserted at Argentina's request. Argentina considers any transfer of goods out of Argentina to be an export which generates taxable income and imposes tax on the sales price as declared for customs valuation purposes less costs. To make an export from Argentina, it is necessary to register as an exporter and keep books in Argentina, so as a practical matter it is generally necessary to establish a fixed place of business in Argentina. Although permitting a purchasing office to be taxed on its "export" activity is a departure from U.S. treaty policy, it is consistent with Argentine policy of treating an export office on the same basis as a subsidiary. Mere purchasing, as referred to in paragraph 4 of Article 7 (Business Profits), refers to purchasing by a U.S. person from an Argentine exporter; in such a case the purchasing activity, whether or not through a permanent establishment, will not generate income subject to tax by Argentina, but a purchasing office which also moves the goods out of Argentina will be taxable in Argentina.

Paragraph 3 provides that a building site or construction or installation project, or an installation or drilling rig or ship used for exploring for or developing natural resources will be considered a permanent establishment if it remains in a Contracting State longer than six months. The six month test applies to each individual site or project. A series of contracts or projects which are interdependent both commercially and geographically is to be treated as a single project for the purpose of applying the six month test. In addition, paragraph 3 provides that a ship used for fishing or for making oceanographic studies is a permanent establishment if it remains in a Contracting State more than 90 days in a tax year. If the site, project, installation or ship remains longer than the specified time period, it constitutes a permanent establishment from the first day.

Paragraph 4 enumerates certain activities which do not constitute a permanent establishment. It is the same as the corresponding paragraph in the U.S. Model.

Paragraphs 5 and 6 refer to the use of agents. Under paragraph 5, a dependent agent acting on behalf of an enterprise who habitually exercises an authority to conclude contracts in the name of the enterprise is deemed to be a permanent establishment of that enterprise, except to the extent that his activities are limited to those mentioned in paragraph 4 which would not constitute a permanent establishment under that paragraph. Paragraph 6 provides that an enterprise of a Contracting State will not be considered to have a permanent establishment in the other State merely because it uses the services of an independent agent acting in the ordinary course of business in that other State.

Paragraph 7 states that control of one company by another does not of itself constitute either company a permanent establishment of the other. The determination as to whether a subsidiary is a permanent establishment of its parent corporation, or conversely, or whether two or more subsidiaries of the same corporation are permanent establishments of the parent or of each other is made by reference to the tests set out in paragraphs 1 through 6.

For purposes of the Treaty, the provisions of this Article also apply in determining whether any person has a permanent establishment in any State. Thus, these principles would determine whether a resident of a third State has a permanent establishment in Argentina or the United States, in applying the Treaty, and whether a resident of Argentina or the United States has a permanent establishment in a third State.

Article 6. INCOME FROM IMMOVABLE PROPERTY (REAL PROPERTY)

This Article provides that income from immovable (i.e., real) property, including income from agriculture and forestry, may be taxed by the Contracting State where the property is located. This rule does not confer an exclusive right of taxation on the State where the property is located, but simply confirms that the situs State has the primary right to tax such income regardless of whether the income is derived through a permanent establishment in that State or not. The Article is substantially the same as paragraphs 1 through 4 of Article 6 of the U.S. Model of May 1977. Paragraph 5 of the U.S. Model providing for a binding election to be taxed on a net basis was deleted. Such an election is available under U.S. law and Argentina taxes on income from real estate on a net basis.

Article 7. BUSINESS PROFITS

This Article provides rules for the taxation by a Contracting State of income from business activity carried on in that State by a resident of the other State.

Paragraph 1 provides that business profits of an enterprise of one Contracting State shall be taxable only in that State except to the extent that such profits are attributable to a permanent establishment through which the enterprise carries on business activities in the other Contracting State. As an exception to this general rule, profits of an enterprise of one State from insuring residents of, or property situated in, the other State may be taxed by the other State even if not attributable to a permanent establishment in that other State. The Argentine tax is imposed on a presumed profit of 10 percent of Argentine source premiums, taxed at the ordinary corporate rate (now 45 percent). The United States will impose the excise tax provided in section 4371 of the Code or, with respect to profits attributable to a permanent establishment, the corporate income tax.

Paragraph 2 provides that the profits to be attributed to a permanent establishment are those which it might be expected to make if it were an independent enterprise engaged in similar activities under similar conditions. The profits so attributed may be from sources within or without a Contracting State. Thus, items of income described in section 864(c)(4)(B) of the Code which are attributable to a permanent establishment in the United States may be taxed by the United States.

However, income that would be taxable under the Code and that is "attributable to" a permanent establishment under paragraph 7 is subject to the provisions of Article 7, even if such income might under the Code be treated as fixed or determinable annual or periodical gains or income not effectively connected with the conduct of a trade or business within the United States. The "attributable to" definition means that the limited "force-of-attraction" rule of Code section 864(c)(3) does not apply for U.S. tax purposes under the Treaty.

Paragraph 3 provides that deductions shall be allowed for expenses incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and general administrative expenses wherever incurred. This paragraph follows the OECD model rather than the longer version of the U.S. Model. Argentina treats branches as separate entities from their home offices. Expenses incurred to produce Argentine source income are deductible, in general, and the remittance is typically subject to a withholding tax. (There are exceptions, such as legal fees and advertising costs, where no withholding tax applies.) Research and development expenses and interest are deductible if paid under an approved contract.

Paragraph 4 states that no profits shall be attributed to a permanent establishment by reason of the mere purchase by it of goods or merchandise for the enterprise. Note, however, under the discussion of Article 5 (Permanent Establishment) that when a foreign person both purchases goods and exports them from Argentina (rather than merely purchasing goods from an Argentine exporter) that activity is not considered by Argentina to be "mere purchase."

Paragraph 5 provides that, unless there is good and sufficient reason to the contrary, the same method of determining profits attributable to the permanent establishment shall be used each year.

Paragraph 6 provides that, where business profits include items of income dealt with in other articles of the Treaty, the provisions of those other articles override the provisions of this Article. For example, the taxation of income of international shipping and aircraft operations dealt with in Article 8 (International Transport) is governed by Article 8 and not by this Article. Similarly, the taxation of dividends, interest, and royalties is controlled by Articles 10, 11, and 12, respectively; however, the terms of those Articles provide that where dividends, interest, or royalties derived by a resident of a Contracting State are effectively connected with a permanent establishment in the other Contracting State, then the provisions of this Article do apply and the item of income is taxed as business profits.

Paragraph 7 provides a definition of the term "business profits" as used in the Treaty. The term does not include any item of income defined as a royalty under paragraph (3) of Article 12.

Article 8. INTERNATIONAL TRANSPORT

This Article provides that each of the Contracting States shall exempt from tax profits derived by an enterprise of the other Contracting State from the international operation of ships or aircraft. Such profits include profits from the incidental rental of ships and aircraft, from the rental of ships or aircraft to a resident of the State of which the lessor is a resident and which uses the vessel in international transport, and from the use of containers and related equipment used in international transport by a resident of that State. A U.S. airline will be exempt from Argentine tax on income from leasing a plane used in international transport (as such income would be treated as profits from the incidental rental of aircraft), but a U.S. bank, for example, will be exempt from Argentine tax on such rental income only if the lessee of the plane is a U.S. resident. Income derived by a U.S. shipping company from the use of containers is exempt from tax by Argentina only if used in international transport by a U.S. resident. These limitations on the exemption at source were requested by Argentina.

Article 9. ASSOCIATED ENTERPRISES

This Article provides that, where related persons engage in transactions which are not at arm's-length, the Contracting States may make appropriate adjustments to their taxable income and tax liability.

Paragraph 1 states the general rule that, where an enterprise of one Contracting State and an enterprise of the other Contracting State are related through management, control, or capital and their commercial or financial relations differ from those which would prevail between independent enterprises, the profits of the enterprises may be adjusted to reflect the profits which would have accrued if the two enterprises were independent.

Paragraph 2 provides that, where one of the Contracting States has made such an adjustment, increasing the profits of an enterprise of that State to the amount that would have accrued had it been independent of the enterprise in the other Contracting State, the second State shall, if it agrees with that adjustment, make a corresponding downward adjustment in the amount of tax which it has already imposed on those profits. In determining such adjustments, due regard is to be paid to the other provisions of the Treaty, including, for example, paragraph 2 of Article 25 (Mutual Agreement Procedure). The competent authorities of the two States may consult each other.

Paragraph 3 clarifies that each Contracting State may apply its internal law in making allocations between related persons. Thus, although paragraphs 1 and 2 refer to allocations of "profits" and "taxes," it is understood that such terms also include the components of the tax base and of the tax liability, such as income, deductions, credits, and allowances. The United States will apply its rules and procedures under section 482 of the Code.

Article 10. DIVIDENDS

This Article limits the rate of tax which may be imposed by either Contracting State on dividends paid by a company which is a resident of that State to a shareholder resident in the other Contracting State.

Paragraph 1 states that such dividends may be taxed in the State of residence of the recipient.

Paragraph 2 provides that such dividends may also be taxed in the State of which the paying company is a resident. But the rate shall not exceed 20 percent of the gross amount of the dividends when the beneficial owner is a resident of the other Contracting State. Further, Argentina agrees that its tax on the profits out of which the dividends are paid and on the dividends may not exceed a combined nominal rate of 45 percent. At present the Argentine corporate tax is 33 percent and the tax on dividends is 17.5 percent, so the combined rate is 44.7 percent (33 plus 17.5 percent x 67). Under the treaty the dividend rate could go as high as 20 percent, but only if the corporate rate is reduced sufficiently (i.e., to not more than 31.25 percent) so that the combined rate does not exceed 45 percent (31.25 plus 13.75 (20 percent x 68.75 percent) = 45 percent). This provision is not intended to limit Argentina's corporate tax rate applicable to U.S. investors to 45 percent in the event that the Argentine withholding tax should be eliminated.

Paragraph 3 defines the term "dividends." It is the same as the definition in the U.S. Model. Each State applies its own law in distinguishing between equity and debt.

Paragraph 4 provides that, where the shares in respect of which dividends are paid are effectively connected with (i.e., the dividends are attributable to) a permanent establishment or a fixed base which the recipient of the dividends maintains in the country of which the company paying the dividend is a resident, those dividends are not taxable in accordance with this Article, but in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services).

Paragraph 5 provides that a Contracting State may not impose tax on dividends paid by a company which is a resident of the other Contracting State unless one of three conditions is met: (a) if, and to the extent that, the beneficial owner of the dividends is a resident of the first Contracting State; (b) where the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or fixed base in the first State; or (c) if 50 percent or more of the gross income of the company is attributable to profits of one or more permanent establishments in that State and the dividends are paid out of such profits. If only condition (c) is met, the limitation of paragraph 2 applies when such dividends are paid to a resident of the other State. Thus, dividends paid by an Argentine company which derived 50 percent or more of its gross income from the profits of a U.S. permanent establishment could be taxed by the United States, but when paid to residents of Argentina the 30 percent U.S. statutory rate would be reduced to 20 percent.

In accordance with paragraph 3 of Article 24 (Non-discrimination), Argentina may impose its branch profits tax on the profits (after corporate tax) of Argentine branches of U.S. companies, but subject to the limitations of paragraph 2(a) of this Article.

Article 11. INTEREST

This Article deals with the taxation by one Contracting State of interest derived and beneficially owned by a resident of the other Contracting State.

Paragraph 1 provides that such interest may be taxed in the State of residence of the recipient.

Paragraph 2 provides that such interest may also be taxed in the State where it arises. The applicable rate is the statutory rate imposed by that State on interest paid to nonresidents. The Treaty does not set a ceiling rate of tax at source (except as provided in paragraph 3). However, paragraph 1 of the Protocol accompanying the Treaty provides that, if the Argentine tax on interest is raised significantly above the level of August 16, 1979, when the draft of the Treaty was initialled, the two States will consult about whether the provisions of this article should be revised. The Argentine rate on August 16, 1979 was 11.25 percent of the gross interest paid (45 percent of 25 percent of the gross amount).

Paragraph 3 provides reciprocal exemption from tax at source of interest derived and beneficially owned by: (1) the other Contracting State or an instrumentality thereof; or (2) a resident of the other State when the debt is guaranteed or insured by that other State or by an instrumentality thereof and was incurred to finance the import of capital goods for industrial use. Thus, interest beneficially owned by the Export-Import Bank or the Overseas Private Investment Corporation (OPIC) will be exempt from Argentine tax. Similarly, interest beneficially owned by a private U.S. lender will be exempt from Argentine tax if the debt is guaranteed or insured by Eximbank or OPIC and is used to finance the import into Argentina of capital goods for industrial use.

Paragraph 4 contains a definition of "interest" as used in the Treaty. It is based on the definition in the U.S. Model.

Paragraph 5 provides that where the debt-claim in respect of which the interest is paid is effectively connected with (i.e., the interest is attributable to) a permanent establishment or fixed base which the recipient of the interest maintains in the other Contracting State, that interest is not taxable in accordance with this Article but in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services).

Paragraph 6 provides a source rule for interest. Interest is deemed to arise in the State of residence of the payer, except where the debt is connected with and the interest is borne by a permanent establishment or fixed base which the payer (whether a resident of a Contracting State or a third country) has in one of the Contracting States; in the latter case the interest is deemed to arise where the permanent establishment or fixed base is situated. Interest is "borne by" a permanent establishment if it is deductible in computing income tax liability in the State where the permanent establishment is located.

Paragraph 7 provides that the provisions of this Article shall not apply to interest payments between related persons in excess of the amount which would have been agreed upon at arm's-length. Such excess amount shall be taxed according to the laws of each Contracting State, with regard also to the other provisions of the Treaty.

Paragraph 8 provides that a Contracting State may not tax interest paid by a resident of the other Contracting State except insofar as one of three conditions is met: the beneficial owner of the interest is a resident of the first State, the debt claim is effectively connected with (i.e., the interest is attributable to) a permanent establishment or fixed base in the first State, or the interest arises in the first State. The United States may tax interest paid by an Argentine corporation in accordance with paragraph 6 and the provisions of its internal law.

Article 12. ROYALTIES

This Article deals with the taxation by a Contracting State of royalties derived and beneficially owned by a resident of the other Contracting State.

Paragraph 1 provides the rule found in the U.S. Model that such royalties may be taxed in the State of residence of the recipient.

Paragraph 2 provides that such royalties may also be taxed in the State where they arise. The applicable rate is the statutory rate imposed by that State on royalties derived by nonresidents. The Treaty does not set a ceiling rate on tax at source. However, paragraph 1 of the Protocol accompanying the Treaty provides that, if the Argentine tax on royalties is raised significantly above the level of August 16, 1979, when the draft of the Treaty was initialled, the two States will consult about whether the provisions of this article should be revised. The Argentine rate on August 16, 1979 was 11.5 percent of the gross amount of copyright royalties (45 percent of 25 percent of the gross amount), 18 percent of the gross amount of other royalties paid under approved contracts (45 percent of 40 percent), and 22.5 percent of gross film rentals (45 percent of 50 percent). Any royalties paid under contracts which are not approved under the terms of the Transfer of Technology Law are subject to tax at 45 percent of the gross amount (and may also be disallowed as a deduction to the payer).

Paragraph 3 contains a definition of the term "royalties." Unlike the U.S. Model, royalties are defined to include rentals of films and tapes and rentals of tangible personal property. The Protocol explains (paragraph 2) that Argentina will tax rentals of equipment net of expenses incurred to produce that income including depreciation, freight and insurance. Royalties are also defined to include payments for "information concerning industrial, commercial or scientific experience." That term does not include fees for technical assistance rendered to a particular client, for example by an accountant, architect or engineer working on a specific project. Rather, it is intended that the term as used in this Treaty means payments for information which has an intrinsic property value, such as plans for building standardized units, computer programs, or advice on how to build a more efficient automobile, i.e., information which might be considered patentable knowledge.

Paragraph 4 provides that where the right or property in respect of which royalties are paid is effectively connected with (i.e., the royalties are attributable to) a permanent establishment or fixed base maintained by the recipient of the royalties in the other Contracting State, the royalties will not be taxed in accordance with the provisions of this Article but in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services).

Paragraph 5 provides that where royalties paid between related persons exceed the amount which would have been determined at arm's-length, the provisions of this Article shall apply only to the arm's-length amount and the excess shall be taxable according to the law of each Contracting State, taking into account the other provisions of the Treaty. This paragraph also appears in the U.S. Model.

Paragraph 6 provides a royalty source rule. Royalties are deemed to arise where the right or property is used.

Article 13. CAPITAL GAINS

This Article provides rules for the taxation of gains, whether ordinary or capital, derived by a resident of a Contracting State.

Paragraph 1 provides that gains derived from the alienation of real property may be taxed by the State where the property is located.

Paragraph 2 provides that gains with respect to movable property forming part of a permanent establishment or a fixed base may be taxed where the permanent establishment or fixed base is located.

Paragraph 3 provides that gains derived by a resident of a Contracting State with respect to the alienation of ships, aircraft, or containers operated in international traffic shall be taxable only in that State. Gains on contingent royalties as described in Article 12 (Royalties) may be taxed in both States, as provided in that Article.

Paragraph 4 provides that gains derived with respect to ships and aircraft not used in international traffic and with respect to motor vehicles may be taxed in the State where the ship, plane or vehicle is documented or registered. This provision is an accommodation to the importance given by Argentina to the source principle of taxation. Argentina does not now tax such gains (it does impose a transfer tax on automobile transfers) but wanted the Treaty to acknowledge the right to tax at source in such cases.

Paragraph 5 expands the rule of paragraph 1 by providing that gains derived from the alienation of stock of a company or of an interest in a trust, estate, or other body of persons whose assets consist principally of real property may also be taxed in the State where the real property is located. The term "real property" for this purpose includes stock or an interest in any entity whose assets consist principally of real property; so that the gain may be taxed by the State where the real property is located, even if the property being alienated is stock of a company which in turn owns a second company which holds the real property in question. The term does not include property (other than rental or agricultural property) in which the business of the company or entity is carried on. This provision was inserted to allow the United States to impose tax in such situations in accordance with its domestic law.

Paragraph 6 provides that gain on the alienation of other tangible personal property may be taxed where the property is located. This provision is an accommodation to Argentina's source basis taxation. Argentina does not now tax nonresidents on gain on corporate securities and, if it should introduce such a tax, will advise the U.S. competent authority (see point 1 of the Protocol).

Paragraph 7 provides that gains from the alienation of any other property shall be taxable only in the State of residence of the alienator. "Other property" would include, for example, intangible assets such as copyrights or patents which are not part of the business property of a permanent establishment or fixed base in the other State.

Article 14. INDEPENDENT PERSONAL SERVICES

This Article concerns the taxation of income derived by a resident of one of the Contracting States from independent personal services, other than as a member of the board of directors of a company which is a resident of the other State. Directors' fees are covered under Article 16.

The rule established in this Article is that a Contracting State may tax income derived by an individual who is a resident of the other Contracting State from performing independent personal services only if two conditions are met. First, the services must be performed in the first-mentioned State. Second, the individual must either (a) be present in that State at least 183 days in the taxable year or (b) have a fixed base regularly available to him in that State for the purpose of performing his activities. If condition (b) applies, only the income attributable to that fixed base may be taxed by the first-mentioned State. It is understood that the term "fixed base" is analogous to the term "permanent establishment." Independent personal services include all personal services performed by an individual for his own account, including services performed as a partner, where he receives the income and bears the losses arising from such services.

Article 15. DEPENDENT PERSONAL SERVICES

This Article concerns the taxation of income derived by residents of one of the Contracting States as employees.

Paragraph 1 provides that, except as otherwise provided in Articles 18 (Pensions, Etc.) and 19 (Government Services), such income may be taxed only in the State of residence unless the personal services are performed in the other Contracting State, in which case the remuneration for those services may be taxed in that other State.

Paragraph 2 provides, however, that, even where the services are performed in the other Contracting State, that other State may not tax the income for such services if three conditions are met: the recipient is present in that State for not more than 183 days in the taxable year; the remuneration is paid by or on behalf of an employer who is not a resident of that State; and the remuneration is not borne by a permanent establishment or a fixed base of the employer in that State. Remuneration is "borne by" a permanent establishment if it is deductible in computing income tax liability in the State where the permanent establishment is located. If any one of these conditions is not met, e.g., if the employer is a resident of that State, the income may be taxed by the State where the services are performed.

Paragraph 3 provides that remuneration for services performed as a member of the regular complement of a ship or aircraft operated in international traffic by a resident of one of the Contracting States may be taxed only by that State.

Article 16. DIRECTORS' FEES

This Article provides that, when a company which is a resident of one Contracting State pays fees to a director who is a resident of the other Contracting State, the former State may tax such fees, but only if and to the extent that the aggregate amount of such fees paid during the taxable year to all directors resident in the other State exceeds $12,000. This provision differs from the rule in the U.S. Model, which treats directors' fees as personal service income or, where appropriate, as a distribution of profits. Argentina prefers the OECD Model, which permits the State of which the paying company is resident to tax fees paid to nonresident directors in all cases. Under the provisions of this Article, Argentina may tax fees paid to U.S. resident directors of Argentine companies, but only to the extent that the total amount of such fees paid to U.S. directors exceeds $12,000 during the year. Argentina taxes such fees at 45 percent of the net amount after deducting expenses incurred to generate the fee. The paying corporation is required to withhold the tax after verifying the deductible expenses.

Article 17. ARTISTES AND ATHLETES

This Article concerns the taxation of income derived by entertainers and athletes who are residents of one of the Contracting States from the performance of services in the other Contracting State.

Paragraph 1 of the U.S. Model provides that such income may be taxed in the other Contracting State only if the gross receipts, including reimbursed expenses, exceed a specified dollar amount for the taxable year ($15,000 in the 1977 Model). Argentina follows the OECD Model, which provides that such income may be taxed in the Contracting State where the services are performed without any minimum amount of earnings or minimum time period. Under this Article, such income may be taxed in the State where the services are performed provided that the gross receipts, including reimbursed expenses, exceed $400 per day the individual is present for the purpose of performing such services or $12,000 in the aggregate for the taxable year. In that event, the full amount may be taxed by the State where the services are performed. Such remuneration may also be taxed by the source State if it does not exceed the amounts specified in Article 17 but meets the conditions for source State taxation set forth in Articles 14 (Independent Personal Services) or 15 (Dependent Personal Services).

Argentina allows deductions for the actual expenses incurred by such persons in Argentina and for their transportation. Alternatively, a deduction may be claimed for a fixed percentage of the remuneration presumed to represent such expenses; the applicable percentage is specified each year. The net amount under either method is taxed at 45 percent, except in the case of certain groups under contract with the Argentine Government or with Argentine charitable institutions in which case the tax is 11.25 percent of the gross amount (45 percent of 25 percent).

Paragraph 2 of this Article also differs from the corresponding provision in the U.S. Model in that it allows the taxation of income from furnishing the services of artists and entertainers in the absence of a permanent establishment or fixed base even when there is no abuse in the form of diverting income for the services rendered by the artist or entertainer to another person. Argentina considers it too difficult to distinguish abuse cases and is concerned at the possible loss of significant amounts of revenue. However, it is agreed that an exemption from tax in the source State will apply where the person to whom the income accrues is exempt from tax in the residence country as a not-for-profit organization, and that where tax does apply, deductions will be allowed for expenses incurred in Argentina and for transportation to and from Argentina. The provision is drafted reciprocally; the United States will tax in accordance with the provisions of the Code the net income of Argentine persons engaged in trade or business in the United States.

Article 18. PENSIONS, ETC.

This Article deals with the taxation of pensions, social security payments, annuities, alimony and child support.

Paragraph 1 provides that pensions in respect of private employment beneficially derived by a resident of one of the Contracting States shall be taxable only in that State, and that public pensions not related to prior employment, such as U.S. social security payments and railroad retirement benefits and Argentine "jubilaciones" paid by one Contracting State to a resident of the other State or to a citizen of the United States shall be taxable only in the paying State. The reference to U.S. citizens is to ensure that a social security payment or similar public pension paid by Argentina to a U.S. citizen resident in Argentina will be taxed only in Argentina and not in the United States. Pensions in consideration of government employment are covered under Article 19 (Government Service).

Paragraph 2 provides that annuities beneficially derived by a resident of a Contracting State may be taxed by both Contracting States but subject to a maximum tax at source of 20 percent of the income component of such payments (amounts received after the return of capital).

Paragraph 3 defines the term "alimony" and provides that alimony paid by a resident of one Contracting State to a resident of the other Contracting State shall be exempt from tax in the first Contracting State to the extent taxable to the recipient in the residence State.

Paragraph 4 defines child support payments and provides that such payments made by a resident of one Contracting State to a resident of the other Contracting State are exempt from tax in both States.

Article 19. GOVERNMENT SERVICE

Paragraph 1 deals with the taxation of income for the performance of governmental functions in one of the Contracting States by a resident of the other Contracting State. The general rule is that such income shall be taxable only in the paying State. However, if the services are rendered in the other State by an individual who is both a resident and a citizen of that State, or who is a resident of that State and did not become a resident solely for the purpose of such employment, the income is taxable only in the State where the services are performed. If an individual does not fall within these exceptions, his spouse and children are not affected by the exception for persons who do not become resident for purposes of employment. For example, if the spouse or children of a U.S. Embassy employee assigned to Buenos Aires were to become employed by the U.S. Government in Argentina after they had taken up residence there, they would not be taxable in Argentina on the grounds that they did not become residents of Argentina solely for purposes of that employment.

Paragraph 2 provides that a pension paid by a Contracting State or a political subdivision or a local authority thereof as consideration for services rendered is taxable only in that State, unless the recipient is both a resident of and a citizen of the other Contracting State, in which case such a pension is taxable only in that other State.

Paragraph 3 states that the provisions of this Article apply only to remuneration and pensions in respect of governmental services. Remuneration and pensions paid to government employees in respect of services performed in connection with a business carried on by a Contracting State or a political subdivision or local authority of a Contracting State are taxable under the applicable provisions of other articles. Whether functions are of a governmental nature is determined by comparison with the concept of a governmental function in the State in which the income arises.

Article 20. STUDENTS AND TRAINEES

Paragraph 1 provides that a resident of one of the Contracting States who goes to the other Contracting State as a student, apprentice or business trainee for the purpose of full-time education or training shall be exempt from tax in that other Contracting State on payments arising from sources outside that State for the purpose of his maintenance, education, or training.

Paragraph 2 provides that an Argentine student, apprentice or trainee who qualifies under paragraph 1 may elect to be treated for U.S. tax purposes as a resident of the United States; i.e., he may elect to be taxed on his world-wide income in the United States and to claim the same deductions and personal exemptions available to U.S. residents. A student making the election under this paragraph would be entitled to make an election under section 6013 to file a joint return with a nonresident alien spouse. If the election is made, the student would be considered a resident of the United States for purposes of this Treaty.

Such an election would benefit a student or trainee with limited income, especially if he is supporting dependents, since a nonresident alien is only allowed one personal exemption and may not use the zero bracket amount. The election would presumably not benefit a student or trainee with large amounts of foreign source income.

Once the election is made, it may not be revoked during the time this Article is applicable, except with the consent of the U.S. competent authority.

Article 21. OTHER INCOME

Paragraph 1 provides that any income of a resident of a Contracting State which arises in the other Contracting State and is not covered by other articles of the Treaty shall be taxable in that other State.

Article 22. TAXATION OF CAPITAL

This Article sets forth rules governing the right to tax various capital assets. The rules parallel those of Article 13 (Capital Gains) concerning the taxation of gain from the alienation of the respective assets. Real property, business property, ships and planes not used in international transport, and tangible personal property other than corporate shares may be taxed where the property is located. Corporate shares and rights may be taxed where the company is resident. These rules do not confer an exclusive taxing right on the State mentioned, but assign the primary taxing right to that State. All other capital of a resident of a Contracting State may be taxed only in that State.

Article 23. RELIEF FROM DOUBLE TAXATION

Paragraph 1 provides that the United States shall give a foreign tax credit for income taxes paid to Argentina, subject to the limitations provided in U.S. law. The taxes referred to in paragraphs (2)(b)(i) and (ii) and 3 of Article 2 (Taxes Covered) are considered income taxes for purposes of the credit. The Treaty guarantee of a foreign tax credit is independent of the statutory grant of a credit under the Code, but the amount of the credit to be allowed is determined in accordance with and subject to the limitations provided in United States law. The Article also confirms the credit provided under section 902 of the Code for taxes paid with respect to the profits of an Argentine company out of which dividends are paid to a United States company which owns at least 10 percent of the voting stock of the paying company.

Argentina exempts from tax all income arising in the United States and derived by a resident of Argentina which, under the Treaty, is not Argentine source income.

The source rules to be used in applying this Article are set forth in paragraph 3.

Dividends are sourced in the State of residence of the paying corporation, or in the United States if paragraph 5(c) of Article 10 (Dividends) applies. The interest source rule is provided in paragraph 6 of Article 11 (Interest) -- the State of residence of the payer or, in some cases, the State where the permanent establishment or fixed base which bears the interest is situated. The royalty source rule is provided in paragraph 6 of Article 12 (Royalties) -- the State where the property is used. Other income is considered to have its source in a Contracting State if the Treaty allows that State to tax it other than by reason of citizenship; and income of a resident of Argentina which may not be taxed by the United States except by reason of citizenship has its source in Argentina.

Article 24. NON-DISCRIMINATION

Paragraph 1 provides that nationals of a Contracting State, wherever resident, shall not be taxed less favorably in the other Contracting State than nationals of that other State who are in the same circumstances. For U.S. tax purposes, United States citizens who are not resident in the United States are not in the same circumstances as Argentine citizens who are not resident in the United States.

In paragraph 2, the United States agreed to adopt the OECD formulation in defining the term "nationals" to include both individuals and legal entities. Thus, "nationals" means all individual citizens of a Contracting State and all legal persons deriving their status as such from the laws in force in a Contracting State. Since for U.S. legal entities nationality and residence will coincide in most cases, the definition of legal persons as nationals is not expected to result in any substantive change compared to the U.S. model.

Paragraph 3 provides that a Contracting State may not impose more burdensome taxes on a permanent establishment of an enterprise of the other Contracting State than it imposes on its own enterprises carrying on the same activities. However, personal tax relief granted to residents of a Contracting State to reflect civil status or family responsibilities need not be granted to residents of the other Contracting State. This provision does not prohibit Argentina from imposing its additional tax on branch profits on the Argentine branches of U.S. companies, but the combined rate of the tax on profits and the additional tax may not exceed the combined rate of tax on profits and on dividends allowed under Article 10 (Dividends).

Paragraph 4 prohibits discrimination in the matter of deductions. Interest, royalties, and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State must be deductible for determining taxable profits under the same conditions as if they had been paid to a resident of the first-mentioned State. "Other disbursements" include, for example, research and development expenses. Similarly, debts incurred by an enterprise of a Contracting State to a resident of the other Contracting State shall be deductible in determining taxable capital under the same conditions as if the debts had been contracted to a resident of the first-mentioned State.

Paragraphs 5 and 6 are the same as the corresponding paragraphs in the U.S. Model. Paragraph 5 requires that a Contracting State not impose more burdensome taxation on a subsidiary corporation owned by residents of the other Contracting State than it imposes on similar corporations which are locally owned. Paragraph 6 provides that, for purposes of this Article, in accordance with the provisions of paragraph 4 of Article 2 (Taxes Covered), taxes of every kind imposed at all political levels shall be covered.

The provisions of this Article do not override the right of the United States to impose the tax provided in Code section 897 (relating to gains derived by nonresident aliens on foreign corporations from U.S. real property interests).

Article 25. MUTUAL AGREEMENT PROCEDURE

This Article provides for cooperation between the competent authorities to resolve problems of double taxation.

Paragraph 1 provides that a taxpayer who considers that the actions of one or both of the Contracting States may result in taxation not in accordance with the Treaty may present his case to the competent authority of the State of which he is a resident or national.

Paragraph 2 provides that the competent authority, if it considers the objection to be justified, and if it is not able to arrive at a solution itself, shall endeavor to resolve the case by mutual agreement with the competent authority of the other Contracting State. Any agreement reached shall be implemented without regard to any statutory time limits of the Contracting States, provided that the competent authority of the other Contracting State has been notified not longer than one year after the taxpayer is notified of a proposed adjustment. Provided that such notice is given in the one year period, a correlative adjustment may be made even though the statute of limitations may have expired, i.e., if it is agreed that tax liability in the first State should be adjusted upward, a refund of the excess tax paid will be made by the other State. However, the U.S. competent authority is not required to reduce or waive a proposed U.S. adjustment, if notice is not given in the prescribed period.

Paragraph 3 provides that the competent authorities shall endeavor to resolve any difficulties or doubts which may arise in the interpretation of application of the Treaty. They may also consult together to eliminate double taxation in cases not foreseen in the Treaty. A number of examples of questions which might be resolved through the mutual agreement procedure are given. It is agreed that the competent authorities may agree on the same allocation of income, deductions, credits or allowances, on the same characterization of items of income, to the same application of source rules with respect to particular items of income, and on a common meaning of a term.

Paragraph 4 provides that the competent authorities may communicate with each other directly for the purpose of reaching agreements in accordance with this Article.

Article 26. EXCHANGE OF INFORMATION

This Article is substantially the same as Article 26 of the U.S. Model.

Paragraph 1 provides that the competent authorities shall exchange such information as is necessary for carrying out the provisions of the Treaty or of their domestic laws concerning taxes covered by the Treaty. It also provides assurances that information so exchanged will be protected in the same manner as information obtained under domestic laws with respect to secrecy and disclosure.

Paragraph 2 explains that the obligation undertaken in paragraph 1 to exchange information does not require a Contracting State to carry out measures contrary to the laws and administrative practice of either State, to supply information not obtainable under its laws or in the normal course of its administration, or to supply information which would disclose trade secrets or other information the disclosure of which is contrary to public policy.

Paragraph 3 states that, when information is requested by a Contracting State in accordance with this Article, the other State shall obtain the information as if the tax in question were a tax of that other State whether or not the case involves a tax liability in that other State. Further, the paragraph specifies that the State to which a request has been made shall provide information in forms usable in the judicial practice of the requesting State, such as depositions of witnesses and copies of unedited original documents, to the extent that such information can be obtained under the laws and practices of the State to which the request is made when enforcing its own taxes.

Paragraph 4 provides that each Contracting State will attempt to collect tax on behalf of the other Contracting State when necessary to ensure that Treaty benefits do not accrue to recipients not intended to derive such benefits. For example, under the Treaty, the U.S. withholding rate of 30 percent on dividends paid to nonresidents is reduced to 20 percent on dividends paid to residents of Argentina. If a third country resident uses an address in Argentina to claim a reduction in the U.S. tax on dividends, Argentina will attempt to collect the additional tax and remit it to the United States. Given the limited scope of withholding rate reductions in the Treaty, this provision is not expected to be widely used. Paragraph 5 specifies that this obligation shall not require either State to undertake measures different from those used in collecting its own tax or contrary to its public policy.

Paragraph 6 provides that, notwithstanding Article 2 (Taxes Covered), for the purposes of this Article the Treaty applies to all taxes at the national level.

Article 28. DIPLOMATIC AGENTS AND CONSULAR OFFICIALS

This Article corresponds to Article 27 of the U.S. Model. It provides that the Treaty shall not affect taxation privileges of diplomatic or consular officials under other special agreements or under international law.

Article 29. ENTRY INTO FORCE

The Treaty is subject to ratification by each Contracting State according to its legal requirements. Instruments of ratification will be exchanged at Washington, D.C. The Treaty enters into force on the exchange of instruments of ratification.

Once in force, the Treaty will have effect, with respect to final withholding taxes, for amounts paid or credited on or after the first day of the second month following the entry into force of the Treaty, and with respect to other taxes, for taxable periods beginning on or after January 1 of the year following the entry into force. For example, if the Treaty were to enter into force in October 1981, any reduction in dividend withholding tax would take effect on December 1, 1981 and for other taxes the Treaty would apply as of January 1, 1982.

Article 30. TERMINATION

The Treaty shall remain in force indefinitely unless terminated by one of the Contracting States. Either Contracting State may terminate the Treaty after five years from the date on which it enters into force by giving at least six months' prior notice through diplomatic channels. In that event, the Treaty will cease to have effect with respect to taxation at the source for amounts paid or credited on or after January 1 following the termination date and with respect to other taxes for taxable periods beginning on or after January 1 following the termination date.

PROTOCOL

A Protocol accompanying and supplementing the Treaty explains four points.

(1) It is agreed that if the rate of Argentine tax on interest or royalties derived by nonresidents increases significantly above the level in effect on August 16, 1979, when the draft of the Treaty was initialled by the two delegations, consultations will take place to determine whether Article 11 (Interest) or 12 (Royalties) should be revised. At the date of the Senate Foreign Relations Committee hearing on the Treaty the Argentine rates had not increased above the August 16, 1979 levels of 11.25 on gross interest and copyright royalties, 18 percent on gross industrial royalties under approved contracts and 22.5 percent on gross film rentals. This paragraph also provides for consultation between the Contracting States if either one should impose an income tax on gains derived by nonresidents on corporate rights other than those covered by Article 13 (Capital Gains).

(2) Argentina will tax rentals of equipment on a net basis after deducting expenses incurred in Argentina and in introducing the equipment into Argentina plus a reasonable allowance for depreciation.

(3) Each State will allow the deductions permitted under its law in taxing the income of residents of the other State from furnishing the services of artists and entertainers. Argentina allows deductions for expenses incurred in Argentina and for transportation costs.

(4) The Argentine tax on remittances abroad in excess of a specified percentage of capital registered in Argentina is not covered by the Treaty. It is considered a penalty tax for remittances contrary to the purposes of Argentina's foreign investment law. The tax is imposed by Article 15 of the Foreign Investment

Law at rates of 15, 20, or 25 percent on remittances of gross dividends and branch profits which over a five year period average more than 14.5 percent of registered capital. One consequence of the tax not being covered is that its creditability for U.S. foreign tax credit purposes will be determined solely under the Code. Similarly, the Treaty does not prevent Argentina from recapturing tax reductions granted to a foreign investor to the extent that the foreign investor remits profits out of Argentina which incur a foreign tax (net of foreign tax credit). The creditability of the Argentine tax on such distributions to U.S. residents will also be determined solely under the Code. It is Argentina's policy not to cover either of these taxes in its tax treaties. The recapture provision is limited in practice by the fact that there are few incentive provisions still in existence; those that remain are primarily for specific activities in less developed regions, such as Tierra del Fuego.

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TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF BANGLADESH FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME SIGNED AT DACCA ON OCTOBER 6, 1980

This Treaty is designed to avoid double taxation and prevent fiscal evasion with respect to taxes on income. It was negotiated on the basis of the U.S. Model Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital published on May 17, 1977, (hereafter referred to as the "U.S. Model"). In general, the U.S. Model reflects the revised Model Double Taxation Convention on Income and on Capital published by the Organization for Economic Cooperation and Development (OECD) in 1977, (hereafter referred to as the "OECD Model"). The Convention incorporates a number of modifications to the U.S. Model, designed principally to reflect Bangladesh's status as a developing country.

The technical explanation is an official guide to the Treaty. It reflects policies behind particular Treaty provisions, as well as understandings reached with respect to the interpretation and application of the Treaty.

Article 1. PERSONAL SCOPE

This Article identifies the persons who come within the scope of the Convention (hereafter referred to as "the Treaty").

Paragraph (1) is taken directly from the U.S. Model, and provides that, except as otherwise provided, the Treaty applies to residents of one or both of the Contracting States. The term "resident" is defined in Article 4 (Fiscal Domicile). The exception refers to certain cases in which the Treaty may also apply to residents of third countries because of their relationship to a resident of a Contracting State or because they are citizens of a Contracting State. For example, Article 25 (Exchange of Information and Administrative Assistance) may apply to an exchange of information concerning residents of third countries.

Paragraph (2) contains the traditional "saving clause" under which each Contracting State reserves the right to tax its residents, as determined under Article 4 (Fiscal Residence), and its citizens as if the Treaty had not come into effect. The

Treaty contains a provision, similar to the U.S. Model, explicitly covering former citizens in the saving clause. Thus, a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of income tax will continue to be subject to U.S. income tax, in accordance with the provisions of section 877 of the Internal Revenue Code of 1954, as amended ("Code"), for a period of ten years following the loss of citizenship.

Paragraph (3) sets forth certain exceptions to the saving clause in which its application would contravene policies reflected in the Treaty which are specifically designed to extend treaty benefits to citizens or residents. For example, under paragraph (3)(a), the saving clause does not affect the benefits provided under paragraphs (1)(b) and (4) of Article 18 (Pensions, Etc.), Article 22 (Relief From Double Taxation), Article 23 (Non-discrimination), and Article 24 (Mutual Agreement Procedure) which are available, notwithstanding the saving clause, to residents and citizens of the Contracting States.

In a second category of exceptions, the saving clause will not override benefits conferred by a Contracting State upon residents who are not citizens of, and do not have immigrant status in, that State. In the case of the United States, "immigrant status" means the individual has been admitted to the United States for permanent residence. For tax purposes, admittance for permanent residence is not required for acquiring residence status. This second category of exceptions includes benefits conferred under Article 19 (Government Service), Article 20 (Teachers, Students and Trainees), and Article 26 (Effect of Convention on Diplomatic Agents and Consular Officers, Domestic Laws, and Other Treaties).

This paragraph differs from paragraph (4) of Article 1 of the U.S. Model only in adding a cross reference to an article covering teachers under subparagraph (b). The U.S. Model does not include an article dealing with teachers such as the one in the Treaty.

Article 2. TAXES COVERED

Paragraph (1) states the general rule that the Treaty applies to income taxes imposed on behalf of a Contracting State. Except for Article 23 (Non-discrimination), the treaty applies only to income taxes imposed at the national level. Paragraph (1) is not intended either to broaden or to limit paragraph (2). Paragraph (2) designates the existing taxes to which the Treaty shall apply. In the case of the United States, these are the Federal income taxes imposed by the Internal Revenue Code, and the excise tax on insurance premiums paid to foreign insurers (Code section 4371), but only to the extent that risks are not reinsured, directly or indirectly, with a person not entitled to relief from such tax. (See paragraph (8) of Article 7 (Business Profits) and the explanation thereto for the effect of covering the insurance premium excise tax in the Treaty.) Like the U.S. Model, the accumulated earnings tax (Code section 531) and the personal holding company tax (Code section 541) are specifically excluded from coverage. Thus, the United States retains the right to impose these taxes under the Treaty.

National taxes not generally covered by the Treaty include, in the case of the United States, the estate, gift, and generation-skipping transfer taxes, the Windfall Profits Tax, Federal unemployment taxes, and social security taxes imposed under sections 1401, 3101, and 3111 of the Code.

In the case of Bangladesh, the covered taxes are the income tax and the super tax. Under paragraph (1) of Article 22 (Relief From Double Taxation), the United States agrees that the Bangladesh taxes enumerated in paragraph (2)(b) and those which may be covered under paragraph (3) of this Article are income taxes for purposes of the U.S. foreign tax credit.

Paragraph (3) provides that the Treaty shall also apply to any taxes imposed subsequent to the date of signature which are substantially similar to the then existing taxes covered by the Treaty. The competent authorities agree to notify each other of any changes in their respective tax laws and of any official published material relating to the application of the Treaty. This provision is substantially the same as paragraph 3 of the U.S. Model.

Paragraph (6) of Article 23 (Non-discrimination) provides that, for purposes of that Article, the Treaty applies to taxes of all kinds imposed at all levels of government, such as capital taxes. This provision corresponds to that found in the U.S. Model. The U.S. Model also extends the taxes covered, for purposes of exchanges of information, to all taxes imposed by a Contracting State. The Treaty does not include such an extension of the coverage because Bangladesh has no authority to exchange information under an income tax treaty with respect to taxes other than income taxes.

Article 3. GENERAL DEFINITIONS

Paragraph (1) defines the principal terms used throughout the Treaty. Unless the context otherwise requires, the terms defined in this paragraph have a uniform meaning throughout the Treaty.

A number of important terms, however, are defined elsewhere in the Treaty. For example, the terms "resident" and "permanent establishment" are defined in Articles 4 (Fiscal Domicile) and 5 (Permanent Establishment), respectively, and the terms "dividends," "interest," and "royalties" are defined in Articles 10 (Dividends), 11 (Interest), and 12 (Royalties).

The term "person" is defined to include an individual, a partnership, a company, an estate, a trust and any other body of persons.

The term "company" means any body corporate or any other entity which is treated as a body corporate for tax purposes.

The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean an enterprise carried on by a resident (as defined by Article 4) of the United States or Bangladesh as the context requires.

The term "international traffic" means any transport by a ship or aircraft except where such transport is solely between places in the other Contracting State. Thus, air transport along the Atlantic coast of the United States is not international traffic. However, if an aircraft operated by a resident of Bangladesh transports goods from Canada to the United States, leaving some of the goods in New York and the remainder in Miami, the entire transport would be international traffic. The definition is relevant principally for purposes of Article 8 (Shipping and Air Transport).

With respect to the United States, the term "competent authority" means the Secretary of the Treasury or his delegate. With respect to Bangladesh, the term means the National Board of Revenue or their authorized representative.

The term "United States" is defined to mean the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam, or any other U.S. possession or territory. The term "Bangladesh" means the People's Republic of Bangladesh. These definitions are sufficiently broad to include Continental Shelf areas, within the meaning of section 638 of the Code.

A "national" of the United States is defined as a citizen of the United States as well as all legal persons, partnerships, and associations deriving their status as such from the laws in force in the United States. A "national" of Bangladesh is defined as an individual possessing the nationality of Bangladesh, and any legal person, partnership, or association deriving its status as such from the laws in force in Bangladesh.

In the U.S. Model, a "national" is defined in the non-discrimination article. However, since the term is used in other Articles of the Treaty as well (e.g., Article 19 (Government Service) and Article 24 (Mutual Agreement Procedure)), the definition is included among the general definitions in Article 3. The U.S. Model defines a national of the United States as a citizen. The addition to the definition of legal persons, partnerships, and associations is taken from the OECD Model. The effect of this expanded definition is to broaden the scope of paragraph (1) of Article 23 (Non-discrimination) which assures that nationals of one Contracting State will be subject to no less favorable treatment in the other Contracting State than the latter accords its own nationals.

Paragraph (2) is similar to the U.S. Model. It provides that terms not defined in the Treaty shall, unless the context requires otherwise, have the meaning which they have under the laws of the Contracting State relating to the taxes to which the Treaty applies. The competent authorities may, however, agree to a common definition of terms under Article 24 (Mutual Agreement Procedure). An agreement by the competent authorities with respect to the meaning of a term used in the Treaty would supercede conflicting meanings in the domestic laws of the Contracting States.

Article 4. FISCAL DOMICILE

This Article sets forth rules for determining the residence of individuals, companies, and other persons for purposes of the Treaty. A definition of residence is important because, in general, only a resident of one of the Contracting States may qualify for the benefits of the Treaty. The definition begins with a person's liability to tax under the respective taxation laws of the Contracting States. A person who, under those laws, is a resident of one Contracting State and not the other need look no further. However, the Treaty definition is also designed to assign residence to one State or the other for purposes of the Treaty in circumstances where each of the Contracting States believes a person to be its resident. The Treaty definition is, of course, exclusively for purposes of the Treaty.

Paragraphs (1) through (5) of this Article correspond to paragraphs (1) through (4) and (6) of Article 4 (Resident) of the U.S. Model, with some minor changes.

Paragraph (1) lists a number of criteria which may be used under the laws of a Contracting State to determine residence, consisting of domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature. Thus, a U.S. citizen living in a third country would be treated as a resident of the United States for purposes of this Treaty. The phrase "any other criterion of a similar nature" includes, for U.S. purposes, an alien present in the United States who elects to be treated as a U.S. resident, and to be taxed on his worldwide income, under Code section 6013(g) or (h). A person liable to tax in a Contracting State only on income from sources in that State is not considered to be a resident of that State for purposes of the Treaty.

When applied with respect to income derived by a partnership, estate, or trust, the term "resident" applies only to the extent that income derived by such partnership, estate, or trust is subject to tax as the income of a resident of a Contracting State either in its hands or in the hands of the partners or beneficiaries. For example, under United States law, a partnership is never, and an estate or trust is often not, taxed as such. Under the Treaty, in the case of the United States, income received by a partnership, estate, or trust will not qualify for the benefits of the Treaty unless such income is subject to tax in the United States as the income of a resident. Thus, in effect, the treatment of income received by a partnership will be determined by the residence and taxation of its partners with respect to that income. To the extent that partners are subject to United States tax as residents of the United States the partnership will be treated as a resident of the United States. Thus, if a United States partnership is comprised of one partner resident in the United States and another partner resident in a third country and the partnership derives dividends from Bangladesh, the limitation of Bangladesh tax under the provisions of Article 10 (Dividends) of the Treaty applies only to the portion of the dividend attributable to the partner who is a resident of the United States. Similarly, the treatment of income received by a trust or estate will be determined by the residence and taxation of the person subject to tax on such income, which may be the grantor, the beneficiaries or the trust or estate itself, as the case may be.

Paragraph (2) provides a series of tie-breaking rules for assigning a single residence to an individual who, under paragraph (1), would be a resident of both countries. The first test is where the individual has a permanent home. If this test is inconclusive because the individual has a permanent home in both countries or in neither of them, his residence is in the State where his center of vital interests lies, i.e., the State with which his personal and economic relations are closer. If such a center cannot be determined, residence is where the individual has an habitual abode. If he has an habitual abode in both countries or in neither of them, he is deemed to be a resident of the State of which he is a national. Should the individual be a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question of residence by mutual agreement.

Paragraph (3) provides that a company which, under paragraph (1), is a resident of both Contracting States because it is incorporated in the United States and has its place of effective management in Bangladesh, shall be considered a resident only of the Contracting State under the laws of which it is created or organized (the United States). Thus, a corporation incorporated under the laws of a state of the United States is a resident only of the United States for purposes of the Treaty, while a corporation which is incorporated in Bangladesh or which has its place of effective management in Bangladesh (and is not incorporated in the United States) may be a resident of Bangladesh.

Paragraph (4) provides that if, under paragraph (1), a person other than an individual or a company is a resident of both Contracting States, the competent authorities shall attempt to agree on a single residence for such person and on how the Treaty applies to such person. This provision applies to persons such as trusts and estates.

Paragraph (5) provides a special rule for cases where income dealt with by the Treaty (e.g., under Articles 7 (Business Profits), 8 (Shipping and Air Transport), 10 (Dividends), 11 (Interest), 12 (Royalties), and 21 (Other Income)), is taxable to a resident of a Contracting State only if, and to the extent, it is remitted to or received by that person. In certain cases, individuals who are residents of Bangladesh are not taxable on foreign source investment income, unless it is remitted to or received by them in Bangladesh. If such income is received outside of Bangladesh, or accumulated by the payer, a Bangladesh resident may not be subject to tax on that income. If the reductions in rates or exemptions from tax were to apply to those items of income, the United States would be foregoing tax where double taxation does not in fact occur. Thus, this paragraph provides that if under the law in the Contracting State of residence income would only be taxed on a remittance basis, then any reduced rates of tax (e.g., as provided by Article 10 (Dividends)), or relief from taxation (e.g., Articles 7 (Business Profits) and 8 (Shipping and Air Transport)) provided by the Treaty in the Contracting State of source shall apply only to the extent such income is remitted to or received by the person in the year in which it accrues to his benefit.

Article 5. PERMANENT ESTABLISHMENT

This Article defines the term "permanent establishment," which is relevant particularly to the taxation of business profits under Article 7 (Business Profits). Paragraph (1), as in the U.S. Model, defines the term "permanent establishment" as a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Paragraph (2) provides an illustrative list of fixed places of business which constitute a permanent establishment. The list includes a place of management, a branch, an office, a factory, a workshop, a store or other sales outlet, a warehouse, and a mine, an oil or gas well, or any other place of extraction of natural resources. The term "place of management" was inserted in paragraph (2) at the request of the Bangladesh delegation to provide greater uniformity with the OECD Model. Since a place of management would in most cases require an office, which is specifically listed in paragraph (2), the insertion of "place of management" will generally not cause a fixed place of business to be a permanent establishment, that would not otherwise be a permanent establishment. The treaty also differs from the U.S. Model by its inclusion of a store or other sales outlet, or a warehouse, as a permanent establishment. The reference to a premises used as a "store or other sales outlet" does not mean that premises used by an enterprise for the mere occasional delivery of goods is a permanent establishment; in such a case, additional significant activity by the enterprise, such as the negotiation of sales and delivery of goods, is necessary for the premises to constitute a permanent establishment of the enterprise. (See the discussion of paragraph (5), below). As a general rule, any fixed facility or premises through which a resident conducts industrial or commercial activity for an indefinite or substantial period of time will be treated as a fixed place of business unless it is used only for the activities described in paragraph (4).

As in the U.S. Model, paragraph (3) provides that a building site or construction or installation project, or an installation or drilling rig used in the exploration for or development of natural resources constitutes a permanent establishment only if a time threshold is met. The Treaty shortens the time threshold from 24 months in the U.S. Model to 183 days. Under the building site or construction or installation project rule, the 183 day period begins only when work physically commences in the other Contracting State. A series of contracts or projects which are interdependent both commercially and geographically is to be treated as a single project for the purpose of applying the 183 day test. The Treaty removes a ship used in the exploration for or development of natural resources from the types of activities will constitute permanent establishments only if the time threshold is satisfied. This broadening of the definition of a permanent establishment is typical of the modifications to the U.S. Model found in treaties with developing countries.

Paragraph (4) lists a number of exceptions to the general rule that a fixed place of business through which the activities of an enterprise are carried on constitutes a "permanent establishment." These exceptions, which do not constitute a permanent establishment, are as follows:

"(a) the use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;

"(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;

"(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

"(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

"(e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

"(f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs (a) to (e) provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character."

Paragraph (4) differs in some respects from paragraph (4) of Article 5 of the U.S. Model. In the U.S. Model, the use of facilities solely for the purpose of delivery of goods or merchandise belonging to the enterprise, or the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of delivery, would not constitute a permanent establishment. Under the Treaty, there are no such automatic exceptions to permanent establishment status. (However, see the discussion of paragraph (5), below). In addition, the Treaty provides that a combination of the activities listed in paragraph (4) will not be deemed a permanent establishment only if the overall activity of the fixed place of business is of a preparatory or auxiliary character. Whether the overall activity of a fixed place of business is of a preparatory or auxiliary character within paragraph (4)(f) is to be determined on the basis of the facts and circumstances.

Paragraph (5) is designed to restrict those situations where mere delivery of goods or merchandise will constitute a permanent establishment. Under this paragraph, the use of facilities or the maintenance of a stock of goods or merchandise belonging to the enterprise for the purpose of occasional delivery of such goods or merchandise will not constitute a permanent establishment. Thus, delivery will have to occur on a regular basis before a permanent establishment can be deemed to exist.

Paragraphs (6) and (7) apply to the use of agents. Under paragraph (6), a dependent agent acting on behalf of an enterprise who habitually exercises an authority to conclude contracts in the name of the enterprise is deemed to constitute a permanent establishment of that enterprise except to the extent that his activities are limited to those mentioned in paragraphs (4) or (5) which would not constitute a permanent establishment when carried on at a fixed place of business. In addition, a dependent agent without such authority, but habitually maintaining in a Contracting State a stock of goods or merchandise belonging to the enterprise from which he regularly fills orders or makes deliveries on behalf of the enterprise is deemed to constitute a permanent establishment of that enterprise if additional activities in that State conducted on behalf of the enterprise, such as the negotiation of contracts, contributed to the sale of the goods or merchandise. Paragraph (7) provides that if an enterprise of one Contracting State makes use in the other Contracting State of a broker or other agent of independent status acting in the ordinary course of their business, it will not thereby be considered to have a permanent establishment in that other State.

Paragraph (8) provides that the fact that a company which is a resident of one Contracting State either controls or is controlled by a company which is a resident of the other Contracting State is not in itself relevant in determining whether a company has a permanent establishment in the other Contracting State. What is relevant is whether one company carries on for the other an activity which, within the provisions of the Article, would make the first company a dependent agent of the other. It follows that the same rules apply to two or more subsidiaries of the same company.

Article 6. INCOME FROM IMMOVABLE PROPERTY (REAL PROPERTY)

Paragraph (1) of this Article provides that income from real property (including income from agriculture or forestry) may be taxed by the Contracting State in which the property is situated. This right, however, is not exclusive; the rule simply confirms that the source State has the primary right to tax such income regardless of whether the income is derived through a permanent establishment in that State.

Paragraph (2) defines real property as having the meaning it has under the laws of the Contracting State in which the property in question is situated. It goes on to specify certain types of property which, regardless of the internal law definitions, are to be included in the treaty definition of real property. With one exception, paragraph (2) is identical to the same paragraph of Article 6 of the U.S. Model. The exception is the addition of equipment used in fishery to the definition of "immovable property." This addition was at Bangladesh's request and reflects the view held by Bangladesh that the income from such property is income from immovable property.

Paragraph (3), which is identical to paragraph (3) in the U.S. Model, provides that the basic rule in paragraph (1) applies to income derived from the direct use, letting, or any other use of immovable property.

Paragraph (4), which is identical to paragraph (4) of the U.S. Model, provides that the rules of this Article apply to the income from immovable property of an enterprise or from immovable property used for the performance of independent personal services.

Paragraph (5) of the U.S. Model, providing for a binding election to be taxed on a net basis, was deleted; such an election is available under U.S. law, and Bangladesh taxes income from real property on a net basis.

Article 7. BUSINESS PROFITS

This Article provides rules for the taxation by a Contracting State of income from business activity carried on in that State by a resident of the other State.

Paragraph (1) provides that the business profits (as defined in paragraph (7)) of an enterprise of one Contracting State shall be taxable only in that State except to the extent that such profits are attributable to a permanent establishment through which the enterprise carries on business in the other Contracting State. The term "permanent establishment" is defined in Article 5 (Permanent Establishment). This rule is found in both the U.S. Model and the OECD Model. Generally, profits "attributable to" a permanent establishment are those derived from the assets or activities of the permanent establishment. Income that would be taxable by the United States under the Code and that is "attributable to" a permanent establishment is subject to the provisions of this Article, however, even if such income might under the Code be treated as fixed or determinable annual or periodical gains or income not effectively connected with the conduct of a trade or business within the United States. The "attributable to" rule means that the limited "force-of--attraction" rule of Code section 864(c)(3) does not apply for U.S. tax purposes under the Treaty. The business profits so attributed may be from sources within or without a Contracting State. Thus, items of income described in Section 864(c)(4)(B) of the Code attributable to a permanent establishment in the United States may be subject to tax by the United States.

In determining the proper attribution of industrial or commercial profits under the Treaty, paragraph (2), also taken from the U.S. Model, provides that the business profits to be attributed to a permanent establishment are those which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions.

Paragraph (3) provides that there shall be allowed as deductions those expenses incurred for the purposes of the permanent establishment, whether incurred in the State where the permanent establishment is located or elsewhere. The deductible expenses include a reasonable allocation of administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole or the part thereof which include the permanent establishment. However, in determining the amount of the deduction under paragraph (3) for expenses incurred by the head office, the deduction generally will be limited to the appropriate share of the expense incurred without including a profit element for the head office.

Paragraph (4) is the same as paragraph (4) of Article 7 of the U.S. Model. It provides that the mere purchase by a permanent establishment of goods or merchandise for the enterprise shall not result in business profits being attributed to the permanent establishment. Paragraph (2) does not override paragraph (4). Thus, where a permanent establishment purchases goods for its head office, the industrial and commercial profits attributed under paragraph (2) to the permanent establishment with respect to its other activities will not be increased by adding a notional figure for profits from purchasing.

Paragraph (5), which is identical to paragraph (5) of the U.S. Model, provides that the same method for determining business profits attributable to a permanent establishment shall be used each year unless there is good and sufficient reason to change. This assures continuous and consistent tax treatment. In the United States, such a change may be a change in accounting method requiring the approval of the Internal Revenue Service.

In an exchange of notes, it was clarified that the profits properly attributed to a permanent establishment may be determined on a reasonable basis if a precise determination of such profits cannot be made or presents exceptional difficulties.

Paragraph (6), which is the same as paragraph (6) of the U.S. Model, provides that where business profits include items of income which are dealt with separately in other articles of the Treaty, then the provisions of those separate articles override the provisions of this Article. Thus, the taxation of income of shipping and aircraft companies dealt with in Article 8 (Shipping and Air Transport) is governed by that Article and not by this Article. Similarly the taxation of dividends, interest, and royalties is controlled by Articles 10 (Dividends), 11 (Interest), and 12 (Royalties); however, the terms of those articles provide that where dividends, interest, or royalties derived by a resident of a Contracting State are effectively connected with a permanent establishment of that resident in the other Contracting State, then the provisions of this Article shall apply.

Paragraph (7) provides a definition of "business profits." The term is defined to mean income derived from any trade or business carried on by any person or group of persons, including the rental of tangible personal property. The primary purpose of that definition in the U.S. Model is to make clear that film rentals and rentals of tangible personal property are business profits, and are therefore subject to the provisions of Article 7, with the result that such income derived by a resident of one Contracting State may not be taxed by the other Contracting State except to the extent attributable to a permanent establishment in the latter State. Such a rule is provided in the Treaty with respect to the rental of tangible personal property. However, Bangladesh objected to defining film rentals as profits. Such income is included in the definition of royalties in the Treaty and thus is subject to the provisions of Article 12 (Royalties). Under this treatment, the source State may tax such payments, as limited by Article 12, whether or not the recipient has a permanent establishment in that State. With this exception, the general definition of business profits is retained in paragraph (7), including specifically the reference to income from the rental of tangible personal property. Like the U.S. Model, this definition applies for purposes of the entire Treaty.

Paragraph (8) does not appear in the U.S. Model, and was inserted at the request of Bangladesh. It merely clarifies that the United States tax on insurance premiums paid to foreign insurers (which is a covered tax under paragraph (2)(a) of Article 2 (Tax Covered)) shall not be imposed on premiums received by an insurance business carried on by a Bangladesh resident, whether or not that business is carried on through a

United States permanent establishment. (In the case of an enterprise with a permanent establishment in the United States, the United States would not impose the insurance excise tax. See Revenue Ruling 80-225). It also reaffirms the rule in paragraph (2)(a) of Article 2 (Taxes Covered) that the exemption from this tax applies only to the extent that the relevant risk is not reinsured, directly or indirectly, with a person not entitled to exemption from such tax under this or another United States tax treaty. This limitation on coverage is intended to clarify that persons not entitled to the benefits of this or another U.S. income tax treaty may not use an insurer in Bangladesh as a conduit for the purpose of obtaining treaty benefits.

Article 8. SHIPPING AND AIR TRANSPORT

Paragraph (1) provides that profits of an enterprise of one of the Contracting States from operating aircraft in international traffic shall be taxable only in that Contracting State. International traffic is defined in paragraph (1)(d) of Article 3 (General Definitions).

By virtue of paragraph (7) of Article 7 (Business Profits), profits of a resident of one Contracting State that are exempt from tax in the other Contracting State under paragraph (1) remain exempt even if the resident has a permanent establishment in that other State.

This provision is subject to the saving clause of paragraph (2) of Article (1) (Personal Scope). Thus, the United States may tax income from international traffic derived by a resident of Bangladesh without regard to this Article if such resident is a citizen of the United States.

Paragraph (2) clarifies what income is to be considered profits from the operation of aircraft. Paragraph (2) states that income from the operation of aircraft in international traffic includes profits from the rental on a full or bareboat basis of aircraft if the lessee operates the aircraft in international traffic or if such rental profits are incidental to other profits described in paragraph (1).

Paragraph (3) provides that the provisions of paragraph (1) applies to profits from the participation in a pool, a joint business, or an international operating agency.

The U.S. Model contains an exemption at source for profits of an enterprise from the operations of ships in international traffic. Bangladesh strongly objected to such a provision. Paragraph (4) provides that the Treaty does not affect the right of a Contracting State to tax, under its domestic law, profits derived by a resident of the other State from sources within the first-mentioned State from the operation of ships in international traffic. However, this rule is specifically subject to the provisions of Article 23 (Non-discrimination), so that United States nationals or permanent establishments may not be subjected to less favorable taxation in Bangladesh than Bangladesh nationals or enterprises carrying on the same activities.

Article 9. ASSOCIATED ENTERPRISES

This Article complements section 482 of the Code and confirms the authority of the United States to allocate items of income, deduction, credit, or allowance under that section. Under paragraph (1), if conditions are made or imposed between related enterprises in their commercial or financial relations which differ from those that would be made between independent enterprises, any profits that would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions have not so accrued may be included in the profits of that enterprise and taxed accordingly. Enterprises are related for purposes of the Treaty where an enterprise of a Contracting State participates directly or indirectly in the management, control, or capital of an enterprise of the other Contracting State, or the same persons (whether or not resident in a Contracting State) participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State.

Paragraph (2) sets forth an explicit formulation of the consequence of a redetermination made in accordance with paragraph (1) by a Contracting State to the income of one of its residents. In such event, the other Contracting State will make an appropriate adjustment to the amount of tax which it charged to the related enterprise. In determining the amount of such adjustment, the other provisions of the Treaty shall be taken into account. Thus, if as a result of the adjustment one enterprise is treated as having made a distribution of profits to the other, the provisions of Article 10 (Dividends) may apply to the deemed distribution. If necessary, the competent authorities are authorized to consult to resolve any differences in the application of these provisions, such as a disagreement over the appropriateness of an adjustment.

Paragraph (3) provides that the provisions of paragraph (1) shall not limit the application of any internal law provisions in either Contracting State designed to place transactions between related enterprises on an arm's-length basis. Thus, this Article does not limit the right of the United States to apply section 482 of the Code, even when such application extends beyond the provisions of Article 9.

Article 10. DIVIDENDS

Under paragraph (1), dividends paid by a company which is a resident of one Contracting State to a shareholder resident in the other Contracting State may be taxed by both States. Although dividends may be taxed by the State in which the company paying the dividends is resident, such tax may not be in excess of the rates specified in paragraph (2). Paragraph (2)(a) provides that the rate of tax shall not exceed 15 percent of the gross amount of the dividends when the beneficial owner of the dividends is a company resident in the other State which owns, directly or indirectly, at least 10 percent of the voting stock of the company paying the dividends. If this test is not met, but the beneficial owner of the dividends is a resident of the other State, the tax rate may not exceed 25 percent of the gross amount of the dividends. These rate limitations do not affect the taxation of profits of the company which pays the dividends.

Paragraph (3) defines the term "dividends" to mean income from shares or similar rights, which are not debt claims and which participate in profits. The term includes income from other corporate rights which is treated as income from shares under the taxation laws of the State of residence of the corporation making the distribution. This definition is also found in the U.S. Model.

Paragraph (4) provides that the limitations of paragraph (2) will not apply where the shares or holding in respect of which the dividends are paid is effectively connected with a permanent establishment or fixed base of the recipient in the country of which the company paying the dividends is a resident. In such a case, the dividends are attributable to the permanent establishment or fixed base and are taxable in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services). If the recipient of the dividend is a citizen of the source Contracting State, that State may tax the recipient without regard to this Article because of the saving clause of paragraph (2) of Article 1 (Personal Scope).

The United States retains its right to impose tax on dividends paid by a Bangladesh company which are considered to have a U.S. source under section 861(a)(2)(B) of the Code.

This Article does not apply to dividends paid by a company which is not a resident of either Contracting State. Such dividends, if they are income of a resident of one of the Contracting States, are subject to tax as provided in Article 21 (Other Income).

Article 11. INTEREST

This Article deals with the taxation by one Contracting State of interest derived and beneficially owned by a resident of the other Contracting State. Paragraph (1) provides that interest derived by a resident of one Contracting State from sources within the other Contracting State may be taxed by both States. However, paragraph (2) provides that interest derived and beneficially owned by a resident of one Contracting State from sources in the other Contracting State may not be taxed by that other State at a rate in excess of 15 percent of the gross amount of the interest. Paragraph (3) provides an exception to the rule in paragraph (2) under which interest derived by the other Contracting State or an instrumentality thereof, including the Federal Reserve Banks, the Export-Import Bank and the Overseas Private Investment Corporation, will be exempt from tax in the Contracting State in which it arises.

Paragraph (4) provides that the limitations of paragraphs (2) and (3) will not apply to interest on a debt-claim which is effectively connected with a permanent establishment or fixed base which the recipient of the interest, a resident of a Contracting State, maintains in the other Contracting State. In such a case, the interest is attributable to the permanent establishment or fixed base and is taxable in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services) rather than under this Article.

If interest is paid to a related person which exceeds an amount which would have been paid to an unrelated person, paragraph (5) states that the provisions of this Article shall not apply to the excess portion of the payment. The excess portion may be taxed by each Contracting State in accordance with its own law, including the Treaty where applicable. In the case of the United States, the excess portion may, for example, be taxed as a dividend, in which case the provisions of Article 10 (Dividends) will apply.

Paragraph (6) contains the definition of "interest" for purposes of the Treaty and is similar to the U.S. Model. Generally, the term includes income from debt-claims of every kind, as well as income assimilated to income from money lent by the taxation law of the Contracting State in which the income arises. The term specifically includes interest on deferred payment sales.

The Treaty does not provide special rules for determining the source of interest payments for purposes of this Article; accordingly, each State may determine such source under its domestic law, subject to an agreement under Article 24 (Mutual Agreement Procedure). Thus, in the case of the United States, absent such an agreement, the source of interest would be determined under section 861(a)(1) of the Code. This Article does not preclude the application by the United States of tax on interest paid by a company resident in Bangladesh if such interest is sourced within the United States under the rules of that Code section. The United States tax on such interest beneficially owned by a Bangladesh resident is limited by paragraph (2) to 15 percent.

This Article is subject to the saving clause of paragraph (2) of Article 1 (Personal Scope). Therefore, interest derived by a citizen of the source Contracting State may be taxed by that State without regard to this Article.

Article 12. ROYALTIES

This Article deals with the taxation by one Contracting State of royalties derived and beneficially owned by a resident of the other Contracting State. Paragraph (1) provides that royalties derived by a resident of a Contracting State from sources within the other Contracting State may be taxed by both States. Paragraph (2) provides that royalties derived and beneficially owned by a resident of one Contracting State from sources within the other Contracting State may not be taxed by that other State at a rate in excess of 10 percent of the gross amount of the royalties, in the case of royalties for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematographic films or films or tapes used for radio or television broadcasting. In all other cases, the other State may not impose tax at a rate in excess of 15 percent of the gross amount of the royalties.

Paragraph (3) contains definitions of various kinds of royalties. Paragraph (3)(a) defines the royalties eligible for the 10 percent rate of tax. Such royalties are described above. Paragraph (3)(b) defines royalties to include payments for the use of, or the right to use, patents, designs, models, plans, secret processes or formulate, trademarks or other similar property or rights, or for information concerning industrial, commercial or scientific experience. Such royalties would be eligible for the 15 percent rate of tax. The term "royalties" does not encompass management fees, which are coverd by the provisions of Article 7 (Business Profits) or 14 (Independent Personal Services), or payments under a bona fide cost-sharing arrangement.

The term "royalties" also includes gains from the alienation of property or rights described in paragraphs (3)(a) and (b) if the amount realized is contingent on the productivity, use, or disposition of such property or rights. If the amounts realized are not so contingent, the provisions of Articles 13 (Capital

Gains) or 21 (Other Income) may apply. The term "royalties" specifically does not include payments in consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Such payments are covered by the provisions of Article 6 (Income from Immovable Property (Real Property)).

The definition of royalties differs in substance from that in the U.S. Model by the inclusion of motion picture royalties (which are treated as business profits in the U.S. Model).

Paragraph (4) provides that the provisions of paragraphs (1) and (2) shall not apply where the right or property in respect of which the royalties are paid is effectively connected with a permanent establishment or fixed base which the recipient of the royalties, a resident of a Contracting State, maintains in the other Contracting State. In such a case, the royalties are attributable to the permanent establishment or fixed base and shall be taxed in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services) rather than in accordance with the provisions of this Article.

If royalties are paid to a related person which exceed an amount which would have been paid to an unrelated person, paragraph (5) states that the provisions of this Article shall not apply to the excess portion of the payment. The excess portion may be taxed by each Contracting State in accordance with its own law, including the Treaty where applicable. In the case of the United States, the excess portion may, for example, be taxed as a dividend, in which case the provisions of Article 10 (Dividends) will apply.

The Treaty does not provide special rules for determining the source of royalty payments for purposes of this Article; accordingly, each State may determine such source under its domestic law, subject to an agreement under Article 24 (Mutual Agreement Procedure). Thus, in the case of the United States, absent such an agreement, the source of royalties would be determined under section 861(a)(4) of the Code.

This Article is subject to the saving clause of paragraph (2) of Article 1 (Personal Scope). Therefore, royalties derived by a citizen of the source Contracting State may be taxed by that State without regard to this Article.

Article 13. CAPITAL GAINS

Paragraph (1) provides that gains derived by a resident of a Contracting State from the alienation of immovable property described in Article 6 (Income from Immovable Property (Real

Property)) and situated in the other Contracting State are taxable in the State where the property is situated. It further provides that gains from the alienation of shares of a company whose assets consist principally of immovable property may be taxed in the State in which that immovable property is situated.

Paragraph (2) provides that a Contracting State may tax gains from the alienation of movable property which is part of the property of a permanent establishment or fixed base in that State maintained by a resident of the other Contracting State. Such gains would include gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base.

Paragraphs (1) and (2) do not confer an exclusive right to tax. Such gains may also be taxed by the State of citizenship or residence of the alienator.

Under paragraph (3), gains derived by an enterprise of a Contracting State from the alienation of ships, aircraft, or containers which it operates in international traffic are taxable only in that State. Though paragraph (3) provides an exclusive right to tax in the Contracting State of residence, that provision is subject to the saving clause of paragraph (2) of Article 1 (Personal Scope). Thus, a resident of Bangladesh who is a citizen of the United States may be subject to United States tax on gains from the alienation of property described in paragraph (3) notwithstanding the provision of that paragraph.

Gains described in Article 12 (Royalties) are not taxable in accordance with this Article but, instead, are taxable in accordance with the provisions of Article 12 (Royalties).

The term "gains" includes amounts taxed as capital gains and as ordinary income.

The Article does not contain provisions dealing with gains other than those described in paragraphs (1) through (3). Accordingly, any other gains are subject to the provisions of Article 21 (Other Income); thus, subject to the saving clause of paragraph (2) of Article 1 (Personal Scope), such gains would be taxable only in the Contracting State of residence unless they arise in the other Contracting State, in which case they would be subject to tax by both States.

Article 14. INDEPENDENT PERSONAL SERVICES

The Treaty provides separate articles dealing with the taxation of income from independent and dependent personal services. Independent personal services are, in general, services performed by an individual for his own account where he receives the income and bears the losses arising from such services. Income from services in which capital is a material income-producing factor, however, will generally be governed by the provisions of Article 7 (Business Profits). Generally, services rendered by physicians, lawyers, engineers, architects, dentists, and accountants who perform personal services as sole proprietors or partners are independent personal services, whereas services performed as an employee or as an officer of a corporation constitute dependent personal services.

This Article provides that income derived by an individual resident of a Contracting State from the performance of personal services in an independent capacity shall be taxable only in that State. However, such income may also be taxed in the other Contracting State if the services are performed in that other State and either (a) the individual is present in that other State for a period or periods aggregating more than 90 days in the taxable year or (b) the income is attributable to a fixed base in that other State which the individual has regularly available to him for the purpose of performing his activities. Under the saving clause of paragraph (2) of Article 1 (Personal Scope), the other Contracting State may also tax any individual who is a citizen of that other State without regard to this Article.

The provisions of this Article differ from the comparable provision in the U.S. Model by the reduction of the time threshold from 183 to 90 days. This is the type of change from the U.S. Model to which U.S. negotiators frequently agree in negotiations with developing countries.

The term "fixed base" is not defined, but a fixed base is generally understood to be similar to a permanent establishment.

Article 15. DEPENDENT PERSONAL SERVICES

This Article is essentially the same as Article 15 of the U.S. Model. Paragraph (1) provides that, subject to the provisions of Articles 18 (Pensions, Etc.) and 19 (Government Service), remuneration derived by a resident of a Contracting State in respect of an employment may be taxed by the other Contracting State only to the extent that the remuneration is for employment performed in that other State. Even in that event, paragraph (2) provides that the remuneration is taxable only in the Contracting State of residence if the recipient is present in the other Contracting State for not more than 183 days in the taxable year, he is paid by or on behalf of an employer who is not a resident of the other State, and the remuneration is not borne as a deduction by a permanent establishment or fixed base of the employer in the other State. Dependent personal service income may also be taxed by that other Contracting State without regard to this Article if the individual is a citizen of that other State, because of the saving clause of paragraph (2) of Article 1 (Personal Scope).

Paragraph (3) provides a special rule for members of the regular complement of ships or aircraft operated in international traffic. Remuneration for such services is taxable only in the Contracting State of which the enterprise operating the ship or aircraft is a resident.

Paragraph (4) provides a special rule for director's fees. Notwithstanding this Article and Article 14 (Independent Personal Services), a director's fee paid by a company resident in one State to an individual who is a resident of the other State and is a shareholder of the company may be taxed by the first-mentioned State at a rate not to exceed 25 percent, but only to the extent that such fee is in excess of the amount which would have been paid for such services to an individual who is not a shareholder of the company.

Article 16. INVESTMENT OR HOLDING COMPANIES

This Article, which is similar to the U.S. Model, provides that a company which (1) is a resident of one Contracting State, (2) 25 percent or more of whose capital is owned directly or indirectly by individuals who are not residents of that Contracting State and (3) which derives dividends, interest, or royalties arising within the other Contracting State, shall not be entitled to claim the benefits of Article 10 (Dividends), 11 (Interest), or 12 (Royalties) if, by reason of special measures, the tax imposed by the first-mentioned Contracting State with respect to such dividends, interest, or royalties is substantially less than the tax generally imposed by that State on company business profits. For purposes of applying this Article, it is intended that the requisite direct or indirect ownership be tested at the individual shareholder level. The source of dividends, interest, and royalties, for purposes of this Article, is determined in accordance with paragraph (3) of Article 22 (Relief From Double Taxation).

The purpose of this Article is to prevent residents of a third country from taking advantage of the reduced rates of withholding provided by the Treaty where one of the Contracting States provides preferential rates of tax for investment or holding companies deriving foreign source income. In the absence of this Article, residents of a third country could organize a corporation in the Contracting State extending preferential rates for the purpose of making investments in the other Contracting

State. The combination of low tax rates in the Contracting State of residence and the reduced rates or exemptions provided in the Treaty in the Contracting State of source would enable such third country residents to realize unintended benefits.

Article 17. ARTISTES AND ATHLETES

This Article deals with the taxation of income derived by entertainers, musicians, and athletes from the performance of services. The Article applies in cases where an artiste or athlete performs services on his own behalf and in cases where services are performed on behalf of another person, as an employee or pursuant to any other arrangement.

Paragraph (1) states the general rule that, notwithstanding the provisions of Article 14 (Independent Personal Services) and Article 15 (Dependent Personal Services), income derived by entertainers such as theatre, motion picture, radio, or television artistes, and musicians, and athletes, for their personal activities as such, may be taxed in the Contracting State where those services are exercised if the income for such services exceeds $100 per day of performance (including rehearsal time) or $3,000 for the taxable year (or equivalents in Bangladesh taka). If the amount of income exceeds $100 per day or $3,000 per year, the full amount, and not just the excess, is subject to tax in the Contracting State in which the services are performed. If the individual receives a fixed amount for performing the services on more than one day, the amount received will be pro-rated over the number of days the individual performs the services.

Paragraph (1) also provides that the Contracting State where the services are exercised may not tax the income if the visit of the entertainers or athletes is within the scope of a cultural or sports exchange program agreed to by both States.

Income derived from services rendered by producers, directors, technicians, and others who are not artistes and athletes is taxable in accordance with the provisions of Article 14 (Independent Personal Services), or Article 15 (Dependent Personal Services), as the case may be.

Paragraph (1) differs from the comparable provision in the U.S. Model (paragraph (1) of Article 17) which sets the dollar threshold at $15,000 of gross receipts (including reimbursed expenses). The broader source country taxation authorized by the Treaty reflects Bangladesh's status as a developing country.

Paragraph (2), which is taken from the U.S. Model, deals with cases in which income in respect of the activities of an entertainer or athlete accrues to a person other than, or in addition to, the entertainer or athlete. Foreign entertainers commonly perform services in the United States as employees of, or contractors for, a company or other person. That person may act as the nominal recipient of the income in respect of the entertainer's services and the entertainer may act as its "employee" or "contractor." In such cases, the company may escape taxation in respect of those services under the provisions of Article 7 (Business Profits) because it does not have a permanent establishment in the United States. The entertainer may also excape taxation by taking a small salary while in the United States and then either receiving payment in a later year when the income is subject to little or no tax, or liquidating the company after the services are performed.

Paragraph (2) provides that income in respect of the personal activities of an artiste or athlete which accrues to the benefit of another person (including a company, trust, or partnership of either Contracting State or any third State), may, notwithstanding the provisions of Articles 7 (Business Profits), 14 (Independent Personal Services), and 15 (Dependent Personal Services), be taxed in the Contracting State in which the activities of the entertainer or athlete take place. Thus, such other person could not claim the permanent establishment protection otherwise provided by Articles 5 (Permanent Establishment) and 7 (Business Profits).

For purposes of paragraph (2), income is considered to accrue to another person if that other person has control over, or the right to receive, gross income derived in respect of the services of an entertainer or athlete. This rule applies regardless of whether the other person is a "sham" or conduit. Income will not, however, be deemed to accrue to the benefit of another person where it is established to the satisfaction of the competent authority of the Contracting State in which the services are performed that neither the entertainer or athlete, nor related persons, participate directly or indirectly in the profits of such other person in any manner, including the receipt of deferred compensation, bonuses, fees, dividends, partnership distributions, or other distributions. Depending on the facts in a particular case, a person may be considered to be related to an entertainer or athlete if he is an employee or agent of the entertainer or athlete or if he is regularly employed by the entertainer or athlete in an advisory capacity, such as his attorney, accountant, or investment advisor. Paragraph (2) does not affect the rule of paragraph (1) that applies to the artiste or athlete himself.

This Article is subject to the saving clause in paragraph (2) of Article 1 (Personal Scope). Thus, an artiste or athlete who is a resident of Bangladesh and a citizen of the United States who performs in the United States would, notwithstanding this Article, be fully subject to U.S. tax.

Article 18. PENSIONS, ETC.

Paragraph (1)(a) provides that pensions and similar remuneration beneficially derived by a resident of one Contracting State in consideration of past employment are taxable only in that State.

Paragraph (1)(b) provides that social security payments and other public pensions (such as U.S. railroad retirement benefits) paid by one of the Contracting States to a resident of the other State or to a United States citizen are taxable only in the paying State. Both paragraphs (1)(a) and (1)(b) are subject to the provisions of paragraph (2) of Article 19 (Government Service). The reference to paragraph (2) of Article 19 places the treatment of pensions for government service under the rules of that Article rather than this one.

Paragraph (2) provides that annuities beneficially derived by a resident of a Contracting State are taxable only in that State. The term "annuities" generally means a stated sum paid periodically at stated times during life or during a specified number of years, under an obligation to make the payments in exchange for full consideration (other than services rendered).

Paragraph (3) provides that alimony paid to a resident of a Contracting State by a resident of the other Contracting State shall be exempt from tax in the other State. The term "alimony" generally means periodic payments made pursuant to a written separation agreement or decree of divorce, separate maintenance or compulsory support which are taxable to the recipient under the internal laws of the Contracting State of which he is resident.

Paragraph (4) provides that periodic payments for the support of a minor child made pursuant to a written separation agreement or a decree of divorce, separate maintenance or compulsory support, paid by a resident of one Contracting State to a resident of the other Contracting State shall be exempt from tax in both States.

Except for paragraphs (1)(b) and (4), this Article is subject to the saving clause of paragraph (2) of Article 1 (Personal Scope). Thus, individuals who are citizens or residents of a Contracting State may be taxed by that State without regard to this Article. Income described in paragraphs (1)(b) and (4) is taxed in accordance with the provisions of those paragraphs, regardless of the citizenship or residence of the recipient.

Article 19. GOVERNMENT SERVICE

Paragraph (1) provides that, as a general rule, remuneration, other than pensions, paid by a Contracting State or a political subdivision or local authority thereof to any individual for services rendered shall be taxable only in that State. It also provides an exception, however, under which such remuneration shall be taxable only in the other Contracting State if the services are rendered in that other State by an individual who is a resident and national of that other State.

Paragraph (2) provides that a pension paid by a Contracting State or a political subdivision or a local authority thereof to any individual as consideration for services rendered to that State or a political subdivision or local authority is taxable only in that State unless the recipient is both a national and a resident of the other Contracting State. In the latter case, such income is taxable only in the other State.

Under paragraph (3), remuneration and pensions in respect of services performed in connection with a business carried on by a Contracting State or a political subdivision or local authority thereof will be treated the same as compensation received from a private employer, and are taxable under the provisions of Article 14 (Independent Personal Services), 15 (Dependent Personal Services), 17 (Artistes and Athletes), or 18 (Pensions, Etc.). Whether functions are of a governmental nature may be determined by reference to the concept of a governmental function in the State in which the income arises.

Pursuant to paragraph (3)(b) of Article 1 (Personal Scope), the benefits of this Article conferred by a Contracting State are not subject to the saving clause of paragraph (2) of Article 1 (Personal Scope), with respect to individuals who are neither citizens of nor have immigrant status in that State. In other cases, the saving clause does apply.

Article 20. TEACHERS, STUDENTS AND TRAINEES

At the request of Bangladesh, the students article in the U.S. Model was expanded to include teachers.

Paragraph (1) provides if an individual was a resident of a Contracting State immediately before becoming temporarily present in the other Contracting State for the purpose of teaching or research at a university, college, school, or other recognized educational institution in that other State, the remuneration paid to him for such work shall not be taxed in that other State for a period not exceeding two years from the date of arrival. The exemption is available only for the first two years after arrival in the other State. If the individual's visit exceeds a period of two years from the date of his arrival, the exemption applies only to the income received by the individual before the expiration of such two year period.

Paragraph (2) deals with an individual who was a resident of a Contracting State immediately before becoming temporarily present in the other Contracting State for the primary purpose of (a) studying at a university, college, or other recognized educational institution, (b) securing training as a business or technical apprentice, or (c) studying or doing research as a recipient of a grant, allowance, or award from a government, religious, charitable, or educational organization. Such individuals shall be exempt from tax in that other Contracting State on (a) payments made to him from abroad for the purpose of his maintenance, education, or training, (b) the grant, allowance, or award, and (c) any remuneration for personal services in an amount not in excess of $4,500 for any taxable year. This exemption for remuneration is available only for services rendered with a view to supplementing the resources available to the individual (i.e. a part-time or summer job).

In the case of an individual who is present in a Contracting State for the purpose of securing training as a business or technical apprentice, the exemption from tax is available only for a period of two years from the date of his first arrival in that State.

Under paragraph (3)(b) of Article 1 (Personal Scope), the benefits conferred by the host Contracting State under this Article are not subject to the saving clause of paragraph (2) of Article 1 (Personal Scope), with respect to individuals who are neither citizens of nor have immigrant status in that State. In other cases, the saving clause does apply. Thus, a citizen of the United States who is a resident of Bangladesh and is in the United States to study at an American university does not benefit from the U.S. exemption accorded by this Article. However, if the individual is not a citizen of the United States, the fact that he may acquire residence (but not immigrant status) in the United States for tax purposes does not deny him the benefits of the Article.

Article 21. OTHER INCOME

Paragraph (1) provides the general rule that any income of a resident of a Contracting State which is not covered by other articles of the Treaty shall be taxable only in the State of residence. This paragraph is relevant primarily with respect to income from sources in third countries. Income having a source in the other Contracting State is dealt with in paragraph (2). The rule of paragraph (1) applies irrespective of whether the Contracting State of residence exercises its right to tax the income covered by the Article.

The items of income covered by this Article include prizes and awards. Most other types of income are specifically dealt with in other articles of the Treaty.

Paragraph (2) excepts from the rule of paragraph (1) income not dealt with in the foregoing Articles derived by a resident of a Contracting State which arises in the other Contracting State. In such cases, the income may be taxed in that other State. The determination of where income arises for this purpose is made under the domestic laws of the respective Contracting States unless the Treaty specifies where the income arises for purposes of determining the right to tax, and may be the subject of an agreement under Article 24 (Mutual Agreement Procedure).

This Article is subject to the saving clause in paragraph (2) of Article 1 (Personal Scope).

Article 22. RELIEF FROM DOUBLE TAXATION

In order to avoid double taxation, each Contracting State agrees in this Article to provide to its citizens or residents a credit against its taxes for taxes paid by such persons to the other Contracting State. Paragraph (1) of this Article is taken from the U.S. Model. It provides that the United States shall give to a citizen or resident a credit for income taxes paid or accrued to Bangladesh, subject to the limitations provided in U.S. law. The Article provides a credit both for taxes imposed on the recipient and an indirect credit to a United States company owning at least 10 percent of the voting stock of a Bangladesh company from which it receives dividends in any taxable year. In this latter case, the United States will allow a credit for the appropriate amount of taxes paid or accrued to Bangladesh by the Bangladesh corporation paying such dividends with respect to the profits out of which the dividends are paid. The taxes referred to in paragraphs (2)(b) and (3) of Article 2 (Taxes Covered) are considered income taxes for purposes of the credit. Whether Bangladesh taxes are paid or accrued is determined under the rules of the Code. This provision does not require the United States to maintain a per-country or overall limitation in the future so long as the general principle of a foreign tax credit remains in effect.

Paragraph (2) provides that, subject to the provisions of Bangladesh law regarding the allowance of a credit, Bangladesh will allow a credit against Bangladesh tax for income taxes paid or accrued to the United States, subject to the limitations provided in Bangladesh law. The paragraph further provides a credit for the underlying United States corporate tax on the profits out of which dividends are paid in the case of dividends from a United States company to a Bangladesh company which owns at least 10 percent of the voting stock of the U.S. company.

The amount of the credit granted under the Treaty is subject to the limitations provided by United States law for the taxable year for the purposes of limiting the credit to the U.S. tax on income from sources outside the United States.

Paragraph (3), which identifies the source of items of income or profits for purposes of this Article, provides the source rules necessary to compute the credit under the Treaty. A taxpayer may, for any year, claim a foreign tax credit under the rules of the Code.

The source of income rules of paragraph (3) are as follows:

Dividends, as defined in paragraph (3) of Article 10 (Dividends), shall be deemed to arise in a Contracting State if paid by a corporation which is a resident of that State.

Interest, as defined in paragraph (6) of Article 11 (Interest), is deemed to arise in a Contracting State when the payer is that State, a political subdivision, a local authority or a resident of that State. If, however, the interest is incurred in connection with a permanent establishment or fixed base in a Contracting State, and the interest is borne as a deduction by that permanent establishment or fixed base, then the interest is deemed to arise in that State, regardless of the residence of the payer.

Royalties, as defined in paragraph (3) of Article 12 (Royalties), shall be deemed to arise in a Contracting State to the extent that the royalties are paid with respect to the use of, or the right to use, rights or property within that State.

All items of income other than dividends, interest, and royalties, derived by a resident of a Contracting State, are deemed to have a source in the other Contracting State if that income may be taxed in that other State in accordance with the Treaty. This rule does not apply to items of income which may be taxed by the United States solely by reason of the saving clause in paragraph (2) of Article 1 (Personal Scope) because the recipient is a citizen of the United States, and income described in paragraph (2) of Article 21 (Other Income).

The saving clause in paragraph (2) of Article 1 (Personal Scope) does not apply to this Article. Thus, the provisions of this Article may be relied upon by a citizen or resident of a Contracting State.

Article 23. NON-DISCRIMINATION

The provisions of this Article are substantially the same as those of Article 24 of the U.S. Model. Paragraph 2 of Article 24 of the U.S. Model contains a definition of the term "nationals" which in the Treaty appears, in a broadened form, in paragraph (1)(h) of Article 3 (General Definitions). As noted below, paragraph (3) deletes some of the material found in the comparable paragraph (paragraph 4) of the U.S. Model.

Paragraph (1) provides that nationals, including legal persons as well as individuals, shall not be treated less favorably with respect to taxation and connected requirements by the other Contracting State than are nationals of that other Contracting State in the same circumstances. For purposes of United States tax, United States citizens who are not residents of the United States are not in the same circumstances as nationals of Bangladesh who are not citizens of the United States. The United States, therefore, is not obligated to treat a national of Bangladesh who is a resident of a third country in the same manner as a United States national who is a resident of that same third country. This paragraph applies to persons who are nationals of, but are not residents of, either the United States or Bangladesh, notwithstanding the provisions of Article 1 (Personal Scope). Thus, paragraph (1) applies to nationals of a Contracting State wherever such national is resident.

Paragraph (2) provides that a Contracting State may not impose more burdensome taxes on a permanent establishment of an enterprise of the other State than it imposes on its own enterprises carrying on the same activities.

Paragraph (3) prohibits discrimination in the allowance of deductions. Except where paragraph (1) of Article 9 (Associated Enterprises), paragraph (5) of Article 11 (Interest), or paragraph (5) of Article 12 (Royalties) applies, interest, royalties, and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State must be deductible for determining taxable profits under the same conditions as if they had been paid to a resident of the first-mentioned State. The U.S. Model contains language explaining that the term "other disbursements" includes a reasonable allocation of executive and general administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related enterprises. That sentence was deleted from the Treaty at Bangladesh's request; however, no change in substance is intended. Paragraph (3) also provides that Bangladesh may continue to require, as a condition of allowing payments of interest, royalties and other disbursements to be deducted in computing taxable income, that any tax imposed on such amounts be withheld at source.

Paragraph (4) requires that a Contracting State not impose more burdensome taxation on a domestic enterprise owned by residents of the other Contracting State than it imposes on similar enterprises which are domestically owned. Paragraph (5) provides that this Article shall not require a Contracting State to grant to residents of the other State any personal allowances, reliefs and reductions for tax purposes which it grants to its own residents.

Paragraph (6) provides that this Article applies to taxes of every kind and description imposed by all levels of government.

The provisions of this Article do not override the right of the United States to impose the tax provided in Code section 897 (relating to gains derived by nonresident aliens or foreign corporations from U.S. real proprty interests).

The saving clause in paragraph (2) of Article 1 (Personal Scope) does not apply to this Article. Thus, a Contracting State may not deny any rights conferred by this Article to its citizens and residents.

Article 24. MUTUAL AGREEMENT PROCEDURE

Paragraph (1) provides that a person who considers that the actions of one or both of the Contracting States result or will result in taxation not in accordance with the Treaty may present the case to the competent authority of the Contracting State of which the person is a resident or national. The person need not be a resident of one of the Contracting States, and need not, although it is anticipated that in the normal situation he will, first have exhausted the remedies available under the domestic laws of the Contracting States.

Paragraph (2) provides that the competent authority, if it considers the objection to be justified and if it is not able to arrive at a solution itself, shall endeavor to resolve the case by mutual agreement with the competent authority of the other Contracting State in order to avoid taxation not in accordance with the Treaty. Any agreement reached shall be implemented without regard to any statutory time limits or other procedural limitations in the domestic laws of the Contracting States. Thus, if it is agreed that tax liability should be adjusted downward, a refund of the excess tax paid will be made even though the statute of limitations of the Contracting State called upon to make the refund may have expired. This waiver of the statute of limitations applies only for refunds and not for the imposition of additional taxes.

Paragraph (3) provides that the competent authorities shall endeavor to resolve by mutual agreement any difficulties or doubts which may arise in the interpretation or application of the Treaty. This paragraph gives examples of the kinds of issues to which the competent authorities may agree. These include: (a) the same attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment in the other Contracting State; (b) the same allocation of income, deductions, credits, or allowances between persons; (c) the same characterization of items of income; (d) the same application of source rules; and (e) a common meaning of a term. The competent authorities may also consult and reach agreement on rules, guidelines, or procedures for the elimination of double taxation in cases not provided for in the Convention. The list of subjects of potential mutual agreement in paragraph (3) is not exhaustive; it merely illustrates the principles set forth in the paragraph. As in the case of other U.S. tax conventions, agreement can be arrived at in the context of determining the tax liability of a specific person or in establishing rules, guidelines, and procedures that will apply generally under the Treaty to resolve issues for classes of taxpayers.

Paragraph (4) provide that the competent authorities may communicate with each other directly for the purpose of reaching agreement in accordance with this Article.

Paragraph (5) provides that the competent authorities may agree to increases in any dollar amounts in the Treaty. Thus, under this provision, if the competent authorities believe that, because of inflation, the $100 or $3,000 thresholds for the taxation of artistes and athletes in paragraph (1) of Article 17 (Artistes and Athletes) is no longer adequate, they may, without having to amend the Treaty formally, agree to a higher amount.

Article 25. EXCHANGE OF INFORMATION AND ADMINISTRATIVE ASSISTANCE

Paragraphs (1) and (2) of this Article are virtually identical to paragraphs (1) and (2), respectively, of Article 26 of the U.S. Model. Since Bangladesh was unwilling to undertake the obligation contained in paragraphs (4) and (5) of the U.S. Model, which deal with assistance in collection where treaty benefits accrue to persons not covered by the Treaty, these paragraphs were deleted. Paragraph (6) of the U.S. Model provides that for the purposes of this Article, the Treaty applies to all national taxes. As noted in the explanation of Article 2 (Taxes Covered), Bangladesh has no authority to exchange non-income tax information under an income tax treaty, and the paragraph was therefore not included. In addition, Bangladesh was unable to agree to the provisions of paragraph (3) of the U.S. Model, dealing with the form in which information is to be supplied to the other state, because of restrictions of domestic law.

Paragraph (1) provides that the competent authorities shall exchange such information as is necessary for carrying out the provisions of the Treaty or of their domestic laws concerning taxes covered by the Treaty. It also provides assurances that information so exchanged will be protected against disclosure in the same manner as information obtained under domestic laws. Information may be exchanged with respect to persons who are not residents of either Contracting State. The competent authorities may exchange information in connection with tax compliance generally, not merely illegal acts or crimes. The Article authorizes a Contracting State to obtain information for the other Contracting State even if there is no tax liability in the State which is requested to obtain the information.

Paragraph (2) explains that the obligation undertaken in paragraph (1) to exchange information does not require a Contracting State to carry out measures contrary to the laws and administrative practice of either State, or to supply information not obtainable under the laws or in normal course of the administration of either State, or to supply information which would disclose trade secrets or other information the disclosure of which would be contrary to public policy.

Article 26. EFFECT OF CONVENTION ON DIPLOMATIC AGENTS AND CONSULAR OFFICERS, DOMESTIC LAWS, AND OTHER TREATIES

Paragraph (1) of this Article corresponds to Article 27 of the U.S. Model. It provides that the Treaty shall not affect taxation privileges of diplomatic or consular officials under the general rules of international law or under the provisions of special agreements.

Paragraph (2) provides that the Treaty shall not restrict any benefit provided by the laws of either Contracting State or by any other agreement between the Contracting States. Thus, if a deduction would be allowed under the Code for an item in computing the taxable income of a Bangladesh resident, such deduction is generally available to him in computing taxable income under the Treaty. Paragraph (2) does not, however, authorize a taxpayer to make inconsistent choices between rules of the Code and rules of the Treaty. Thus, if a taxpayer claims the benefits of a provision of the Treaty, he must use the rules of the Treaty relevant to such benefit, and must use such rules consistently. For example, if a resident of Bangladesh desires to claim the benefits of the "attributable to" rule of paragraph (1) of Article 7 (Business Profits) with respect to the taxation of business profits of a permanent establishment, such person must use the "attributable to" concept consistently for all items of income and deductions and may not rely upon the "effectively connected" rules of the Code with respect to other items of income otherwise attributable to a permanent establishment. In no event are the rules of the Treaty to increase U.S. or Bangladesh tax liability from what that liability would be if there were no treaty. It follows that a right to tax under the Treaty cannot be exercised unless that right also exists under the Code.

Article 27. ENTRY INTO FORCE

Paragraph (1) provides that the Treaty be ratified by the Contracting States in accordance with their applicable procedures and that instruments of ratification be exchanged as soon as possible.

Paragraph (2) provides that the Treaty will enter into force upon the exchange of instruments of ratification. Once the Treaty enters into force, it will have effect with respect to tax withheld at source, to amounts paid or credited on or after the first day of the second month next following the date on which the Treaty enters into force. With respect to other taxes, the Treaty will have effect to taxable periods in the United States and income years in Bangladesh beginning on or after the first day of January next following the date on which the Treaty enters into force.

Article 28. TERMINATION

The Treaty shall remain in force indefinitely unless terminated by one of the Contracting States. Either Contracting State may terminate the Treaty after five years from the date on which it enters into force by giving at least six months' prior notice through diplomatic channels. In that event, the Treaty will cease to have effect in respect of taxes withheld at source, to amounts paid or credited on or after the first day of January next following the expiration of the six months' period. In respect of other taxes, the Treaty will cease to have effect to taxable periods in the United States and income years in Bangladesh beginning on or after the first day of January next following the expiration of the six months' period.

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TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE ARAB REPUBLIC OF EGYPT FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME SIGNED AT CAIRO ON AUGUST 24, 1980

INTRODUCTION

This is a technical explanation of the Convention between the United States and Egypt, signed on August 24, 1980 ("the Convention"). This explanation is an official guide to the Convention. It reflects policies behind particular Convention provisions, as well as understandings reached with respect to the interpretation and application of the Convention.

Article 1. TAXES COVERED

Paragraph (1) designates the taxes of the Contracting States which are the subject of the Convention. With respect to the United States, the subject taxes are the Federal income taxes imposed by the Internal Revenue Code ("Code"). The United States taxes imposed under Code sections 531 (accumulated earnings tax) and 541 (personal holding company tax) are excluded, thus preserving for the United States the right to impose these taxes.

United States taxes not generally covered by the Convention include the estate, gift, and generation skipping transfer taxes, the Windfall Profits Tax, Federal unemployment taxes and social security taxes imposed under sections 1401, 3101 and 3111 of the Code.

In the case of Egypt, paragraph (1) provides that the Convention applies to the tax on income derived from immovable property (including the land tax, the building tax and the ghaffir tax); the tax on income from movable capital; the tax on commercial and industrial profits; the tax on wages, salaries, indemnities and pensions; the tax on profits from liberal professions and all other noncommercial professions; the general income tax; the defense tax; the national security tax; the war tax; and all supplementary taxes imposed as a percentage of any of the previously mentioned taxes.

Pursuant to paragraph (2), the Convention will also apply to taxes substantially similar to those covered by paragraph (1) which are imposed in addition to, or in place of, existing income taxes, after August 24, 1980, (the date of signature of the Convention).

Under paragraph (3), for purposes of Article 26 (Non-discrimination), the Convention applies to taxes of every kind imposed at the national, state, or local level; and for purposes of Article 28 (Exchange of Information), the Convention applies to taxes of every kind imposed at the national level.

Paragraph (4) provides that the competent authority of each Contracting State will promptly notify the competent authority of the other Contracting State of any amendment of the tax laws referred to in paragraph (1), or of the adoption of substantially similar taxes imposed in addition to, or in place of, those taxes by transmitting the texts of such amendments or statutes. Paragraph (5) provides for a similar exchange with respect to the publication of official material concerning the application of the Convention, whether in the form of regulations, rulings or judicial decisions.

Article 2. GENERAL DEFINITIONS

Paragraph (1) sets out definitions of certain basic terms used in the Convention. Unless the context otherwise requires, a term defined in this paragraph has a uniform meaning throughout the Convention. A number of important terms, however, are defined elsewhere in the Convention.

The term "United States" means the United States of America. When used in a geographical sense, the term means the states of the United States and the District of Columbia. Thus, the Convention does not apply to the possessions of the United States or the Commonwealth of Puerto Rico. The term "Egypt" means the Arab Republic of Egypt.

When used in a geographical sense, the terms "United States" and "Egypt" also include their respective territorial seas, and in general accord with the principles of section 638 of the Code, their respective continental shelves.

The term "Contracting State" is defined to mean the United States or Egypt as the context requires. The term "State" means the United States, Egypt, or any other national State.

The term "person" includes an individual, a partnership, a corporation, an estate or a trust.

The term "United States corporation" is defined as a corporation, or any unincorporated entity which is treated as a corporation for United States tax purposes, which is created or organized under the laws of the United States, any state thereof, or the District of Columbia. An "Egyptian corporation" is defined as a corporation, or any unincorporated entity which is treated as a corporation for Egyptian tax purposes, which is created or organized under the laws of Egypt.

With respect to the United States, the term "competent authority" means the Secretary of the Treasury or his delegate. With respect to Egypt, it means the Minister of Finance or his delegate. The term "tax" means those taxes imposed by the United States or Egypt to which the Convention applies by virture of Article 1 (Taxes Covered).

The term "international traffic" is defined as any voyage of a ship or aircraft operated by a resident of one of the Contracting States except where such voyage is confined solely to places within a Contracting State. Thus, for example, coastal shipping along the Atlantic coast of the United States is not a voyage in international traffic. However, if a ship operated by a resident of Egypt transports goods from Canada to the United States, leaving some of the goods in New York and the remainder in Norfolk, the portion of the voyage between New York and Norfolk is international traffic.

Paragraph (2) provides that any term used in the Convention which is not defined therein shall, unless the context otherwise requires, have the meaning which it has under the laws of the Contracting State whose tax is being determined. However, where a term has a different meaning under the laws of Egypt and the United States, or where the meaning under the laws of one of the Contracting States is not readily determinable, the competent authorities may for purposes of the Convention establish a common meaning, which may differ from the meaning under the laws of either Contracting States, in order to prevent double taxation or to further any other purpose of the Convention.

Article 3. FISCAL RESIDENCE

This article sets forth rules for determining the residence of individuals, corporations, and other persons for purposes of the Convention. Residence is important because, in general, only a resident of one of the Contracting States may qualify for the benefits of the Convention. The Convention definition is, of course, exclusively for purposes of the Convention.

Under paragraph (a), the term "resident of Egypt" means an Egyptian corporation (as defined in paragraph (1)(f)(ii) of Article 2 (General Definitions)) or any other person (except a corporation or any entity treated under Egyptian law as a corporation) resident in Egypt for purposes of Egyptian tax. Similarly, "resident of the United States" means a United States corporation (as defined in paragraph (1)(f)(i) Article 2 (General Definitions)) and any other person (except a corporation or any entity treated as a corporation for United States tax purposes) resident in the United States for purposes of United States tax. Thus, a resident of the United States includes a resident alien individual, an alien present in the United States who elects to be treated as a resident under Code section 6013(g) or (h), and a resident citizen, but under no circumstances, a foreign corporation. A citizen of the United States or Egypt is not automatically a resident of the United States or Egypt for purposes of the Convention. Residence for this purpose is to be determined in accordance with the principles of Treasury regulations under section 871 of the Code.

The Convention provides that a partnership, estate, or trust is a resident of a Contracting State only to the extent that the income derived by such person is subject to tax in such Contracting State as the income of a resident. For example, under United States law, a partnership is never, and an estate or trust is often not, taxed as such. Under the Convention, in the case of the United States, income received by a partnership, estate, or trust will not qualify for the benefits of the Convention unless such income is subject to tax in the United States as the income of a resident. Thus, in effect, the treatment of income received by a partnership will be determined by the residence and taxation of its partners with respect to that income. To the extent that partners are subject to United States tax as residents of the United States, the partnership will be treated as a resident of the United States. Similarly, the treatment of income received by a trust or estate will be determined by the residence and taxation of the person subject to tax on such income, which may be the grantor, the beneficiaries or the trust or estate itself, as the case may be.

An individual who is a resident of one Contracting State under its laws and is not a resident of the other need look no further to determine his residence under the Convention. However, where he is a resident of each Contracting State under its laws, paragraph (2) of the Article must be used to determine that person's residence under the Convention.

Under paragraph (2), an individual who is a resident of both Contracting States under paragraph (1) will be deemed to be a resident of the Contracting State in which he has his permanent home, his center of vital interests (closest personal and economic relations), an habitual abode, or his citizenship, in the order listed. If the issue is not settled by these tests, the competent authorities will decide by mutual agreement the one Contracting State of which he will be considered to be a resident.

Article 4. SOURCE OF INCOME

This article contains the source rules which are to be used in applying the provisions of the Convention. For example, under Article 6 (General Rules of Taxation), one Contracting State may tax a resident of the other Contracting State only on income from sources within the first-mentioned Contracting State (provided, with certain exceptions, such resident is not a citizen of the first-mentioned Contracting State).

Paragraph (1) provides that, as a general rule, dividends will be treated as income from sources within a Contracting State only if paid by a corporation of the Contracting State. This general rule will not apply in two cases. First, dividends paid by a United States corporation will be treated as income from sources within Egypt if such corporation's activities lie solely or mainly in Egypt and the dividend is taxed in Egypt in the manner prescribed in paragraphs (3) and (5) of Article 11 (Dividends). This rule is similar to that of Code sections 861(a)(2)(A) and 862(a)(1). See the explanation of paragraph (5) of Article 11 (Dividends) for a discussion of the effects of this rule. Second, dividends paid by a corporation other than a United States corporation will be treated as income from sources within the United States if at least 50 percent of such corporation's gross income from all sources for the 3-year period (or such part of that period as the corporation has been in existence) ending with the close of its taxable year preceding the declaration of the dividend was industrial or commercial profits attributable to a permanent establishment which such corporation had in the United States. The rule in the second case, though similar, differs from that of Code section 861(a)(2)(B) in that, for example, it does not specifically provide that only a pro rata portion of the dividend will be treated as income from sources within the United States. However, since Article 6 (General Rules of Taxation) provides, in effect, that the Convention will not increase a person's United States tax, the pro ration specified in Code section 861(a)(2)(B) will be applied to determine the portion of the dividend paid by such non-United States corporation which will be treated as United States source income.

Under paragraph (2), interest will be treated as income from sources within a Contracting State only if paid by the Contracting State, a political subdivision or a local authority thereof, or by a resident of the Contracting State. However, if interest is paid on an indebtedness incurred in connection with a permanent establishment which bears such interest, (i.e., deducts the interest in computing the income of the permanent establishment) then such interest shall be deemed to be from sources within the State (whether or not a Contracting State) in which the permanent establishment is situated. This exception permits a Contracting State, under the proper circumstances, to impose a tax on interest paid by a permanent establishment of a resident of a State other than a Contracting State. For example, if a resident of France has a permanent establishment in Egypt which borrows money from a resident of the United States and bears the interest, the interest will be deemed to be from Egyptian sources. Thus, Egypt may tax such interest, subject to the limitation of Article 12 (Interest). As provided in paragraph (8) of Article 5 (Permanent Establishment) the principles of Article 5 will be applied to determine whether the resident of France has a permanent establishment in Egypt. The United States will not, because of sections 861(a)(1)(C) and (D) of the Code, impose a tax on interest received by nonresident alien individuals or foreign corporations from a foreign corporation having a permanent establishment in the United States unless 50 percent or more of the gross income of such corporation from all sources for the three year period ending with the close of its taxable year preceding the payment of the interest (or such part of such period as the corporation has been in existence) was effectively connected with the conduct of a trade or business within the United States. If it is, the U.S. will impose a tax on a pro rata portion of the interest.

In addition, the exception to the general rule of paragraph (2) of this article will exempt interest from tax in the Contracting State in which the payor resides if the payor has a permanent establishment in a State other than a Contracting State in connection with which the indebtedness on which the interest is paid was incurred, such interest is borne by the permanent establishment and such interest is paid to a resident of the other Contracting State. This results from the restriction in Article 6 (General Rules of Taxation) that a resident of one Contracting State, not a citizen of the other Contracting State, may be taxed by the other Contracting State only on income from sources within that other Contracting State.

Paragraph (3) provides that royalties for the use of, or the right to use, property or rights described in paragraph (2) of Article 13 (Royalties) will be treated as income from sources within a Contracting State only to the extent that such royalties are for the use of, or the right to use, such property or rights within that Contracting State.

Paragraph (4) provides that income and gains (including royalties) to which Article 7 (Income from Real Property) applies will be treated as income from sources within a Contracting State only if the real property is situated in that Contracting State. As noted in Article 7, paragraph (4) determines not only the source of a gain from the alienation of real property itself, but also of gains from the alienation of shares of a corporation, or of an interest in a partnership, estate, or trust the property of which consists principally of real property situated in a Contracting State.

Paragraph (5) provides that income from the rental of tangible personal (movable) property will be treated as income from sources within a Contracting State only if such property is situated in that Contracting State.

Under paragraph (6) income from the purchase and sale, exchange, or other disposition of intangible or tangible personal property (other than gains described in paragraph (2) of Article 13 (Royalties)) will be treated as income from sources within a Contracting State only if such sale, exchange, or other disposition is within that Contracting State.

Under paragraph (7), income received by an individual for his performance of labor or personal services, whether as an employee or in an independent capacity, will be treated as income from sources within a Contracting State only to the extent that such services are performed in that Contracting State. Income from personal services performed aboard ships or aircraft operated by a resident of a Contracting State in international traffic will be treated as income from sources within that Contracting State if rendered by a member of the regular complement of the ship or aircraft. However, remuneration described in Article 21 (Governmental Functions), and payments described in Article 20 (Social Security Payments) paid from the public funds of a Contracting State or political subdivision or local authority thereof will be treated as income from sources within that Contracting State only.

Paragraph (8) contains a general qualification to the preceding source rules. It provides that industrial or commercial profits attributable to a permanent establishment which the recipient, a resident of one Contracting State, has in the other Contracting State will be treated as income from sources within that other Contracting State. Industrial or commercial profits attributable to such permanent establishment may include any item of income described in paragraphs (1) through (6) if the item of income is "effectively connected" with the permanent establishment. See the discussion of paragraph (6) of Article 8 (Business Profits) for a discussion of the effectively connected concept.

Under paragraph (9), the source of any item of income not described in the preceding paragraphs of Article 4 will be determined by each Contracting State in accordance with its own law. However, if the source of any item of income under the laws of one Contracting State is different from its source under the laws of the other Contracting State or if its source is not readily determinable under the laws of one of the Contracting States, the competent authorities of the Contracting State may, in order to prevent double taxation or further any other purpose of the Convention, establish a common source of the item of income for purposes of the Convention. (See paragraph (2)(c) of Article 27 (Mutual Agreement Procedure)).

Several of the source rules set out in this article differ to some degree from those provided in the Code. Since Article 6 (General Rules of Taxation) provides, in effect, that the Convention will not increase a person's overall United States tax, a taxpayer is not required to apply the Convention rules in calculating his United States tax liability. However, a taxpayer may not make inconsistent choices between Code and Convention rules.

Article 5. PERMANENT ESTABLISHMENT

This article defines the term "permanent establishment." The existence of a permanent establishment is relevant under Article 8 (Business Profits) to the taxation of industrial or commercial profits and in determining the applicability of other provisions of the Convention.

Under paragraph (1), the term "permanent establishment" means a fixed place of business through which a resident of one of the Contracting States engages in industrial or commercial activity. Illustrations in paragraph (2) of a permanent establishment include a seat of management; a branch; an office; a factory; a workshop; a mine, quarry or other place of extraction of natural resources; and the maintenance of a building site or construction or installation project which exists for more than six months. A drilling rig is included within this rule. Under the construction or installation project rule the six month period begins only when work physically commences in the other Contracting State. A series of contracts or projects which are interdependent both commercially and geographically is to be treated as a single project for the purpose of applying the six months test. As a general rule, any fixed facility or premises through which a resident conducts industrial or commercial activity for an indefinite or substantial period of time will be treated as a permanent establishment unless it is used only for one or more of the activities described in paragraph (3).

Paragraph (3) specifically provides that a permanent establishment does not include a fixed place of business if it is used only for one or more of the following:

> "(a) The use of facilities for the purpose of storage, display, or delivery of goods or merchandise belonging to the resident;
>
> "(b) The maintenance of a stock of goods or merchandise belonging to the resident for the purpose of storage, display, or delivery;
>
> "(c) The maintenance of a stock of goods or merchandise belonging to the resident for the purpose of processing by another person;
>
> "(d) The maintenance of a fixed place of business for the purpose of purchasing goods or merchandise, or for collecting information, for the resident;
>
> "(e) The maintenance of a fixed place of business for the purpose of advertising, or for similar activities which have a preparatory or auxiliary character, for the resident; and
>
> "(f) The maintenance of a building site or construction or installation project which does not exist for more than 6 months."

As noted, these exceptions are cumulative and a fixed place of business used only for one or more of these purposes will not be considered a permanent establishment under the Convention.

Under paragraph (4), a person acting in one Contracting State on behalf of a resident of the other Contracting State, other than an agent of an independent status to whom paragraph (5) applies, will be deemed to constitute a permanent establishment if such person has, and habitually exercises in that first-mentioned Contracting State, an authority to conclude contracts in the name of the resident, unless the exercise of the authority is limited to the purchase of goods or merchandise for the resident.

On the other hand, paragraph (5) provides that a resident of one Contracting State will not be deemed to have a permanent establishment in the other Contracting State merely because such resident engages in industrial or commercial activity in such other Contracting State through a broker, general commission agent, or any other agent of an independent status, where such broker or agent is acting in the ordinary course of his business.

Paragraph (6) provides that a resident of one Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because such resident sells at the termination of a trade fair or convention in the other Contracting State goods or merchandise which were displayed by such resident at the trade fair or convention. The trade fair exception is not intended to apply with respect to goods in the resident's inventory.

Under paragraph (7), the determination of whether a resident of one Contracting State has a permanent establishment in the other Contracting State is to be made without regard to the fact that such resident may be related to a resident of the other Contracting State or to a person who engages in business in that other Contracting State (whether through a permanent establishment or otherwise). As defined in Article 10 (Related Persons), a person is related to another person if either person owns or controls directly or indirectly the other, or if a third person or persons own or control directly or indirectly both.

Paragraph (8) provides that the principles set forth in this article are to be applied in determining whether there is a permanent establishment in a State other than one of the Contracting States or whether a person other than a resident of one of the Contracting States has a permanent establishment in one of the Contracting States. This is necessary for the proper application of paragraph (2) of Article 4 (Source of Income). This paragraph is not intended to extend the benefits of the Convention to persons other than residents of the two Contracting States.

Article 6. GENERAL RULES OF TAXATION

Under paragraph (1), a resident of one Contracting State may be taxed by the other Contracting State on any income from sources within that other Contracting State and only on such income, subject to the limitations set forth in the Convention. For this purpose, the source rules contained in Article 4 (Source of Income) are to be applied. However, if the resident is a citizen of the other Contracting State, that Contracting State may tax the resident without regard to this paragraph because of the saving clause of paragraph (3) of this article.

Paragraph (2) contains the customary rule that the Convention will not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded by the laws of a Contracting State in the determination of a tax imposed by it, or by any other agreement between the Contracting States. Thus, if a deduction would be allowed under the Code for any item in computing the taxable income of an Egyptian resident, such deduction is generally available to such person in computing taxable income under the Convention. Paragraph (2) does not, however, authorize a taxpayer to make inconsistent choices between rules of the Code and rules of the Convention. In no event may the Convention increase the overall tax burden on residents of the Contracting States. Thus, a right to tax given by the Convention cannot be exercized unless that right also exists under the Code.

Paragraph (3) contains the traditional saving clause under which the United States reserves the right to tax its citizens and residents as if the Convention had not come into effect. However, because of paragraph (4), the saving clause does not apply in several cases in which its application would contravene policies reflected in the Convention which are specifically designed to extend treaty benefits to citizens or residents. Thus, the saving clause does not affect the provisions with respect to child support, social security payments, relief from double taxation, nondiscrimination, or the mutual agreement procedure. Moreover, the saving clause does not affect the benefits of the Convention granted to individuals performing governmental functions, teachers, students, trainees, and diplomatic or consular officers who are neither citizens of, nor have immigrant status in, the Contracting State imposing the tax. In the case of the United States, "immigrant status" means the individual has been admitted to the United States for permanent residence. The saving clause is reciprocal.

Paragraph (5) authorizes the competent authorities of the Contracting State to prescribe regulations necessary to carry out the provisions of the Convention. For the United States, this authority is also provided by section 7805 of the Code.

Article 7. INCOME FROM REAL PROPERTY

Under paragraph (1), income from real property, including royalties and other payments in respect of the exploitation of natural resources (e.g., oil wells), gains from the sale, exchange or other disposition of such property or the right giving rise to such royalties or other payments, and interest on indebtedness secured by real property (e.g., mortgages) or secured by a right giving rise to royalties or other payments in respect of the exploitation of natural resources, may be taxed by the Contracting State in which the real property or natural resources are situated. Thus, natural resource royalties are covered under this Article and not under Article 13 (Royalties).

Under paragraph (2), paragraph (1) applies to income derived from the usufruct, direct use, letting, or use in any other form of real property.

Paragraph (3) provides, consistent with U.S. law, that gains from the alienation of shares of a corporation or of an interest in a partnership, estate, or trust, the property of which consists, directly or indirectly, principally of real property situated in a Contracting State, shall be regarded as income from real property. Thus, under paragraph (1) of the Article, such gains may be taxed in the Contracting State in which the real property is situated, and under paragraph (4) of Article 4 (Source of Income), the gain is treated as having its source in that State.

Paragraph (4) emphasizes what is clearly implied in paragraph (1), that income from real property (including that referred to in paragraph (3)) may be taxed by both the State of residence and the State in which the real property is situated.

This Article does not contain a provision allowing for the taxation or real property income on a net basis. This is because such treatment is already provided for under the laws of both Contracting States.

Article 8. BUSINESS PROFITS

Paragraph (1) sets forth the general rule that industrial or commercial profits of a resident of one Contracting State are exempt from tax by the other Contracting State unless the resident has a permanent establishment in the other Contracting State. Where there is a permanent establishment, only the industrial or commercial profits attributable to the permanent establishment can be taxed by the other Contracting State, unless the resident is a citizen of that other Contracting State. (See the saving clause in paragraph (3) of Article 6 (General Rules of Taxation)). Under paragraph (6) of Article 4 (Source of Income), industrial or commercial profits whether from sources within or without a Contracting State attributable to a permanent establishment which a resident of one Contracting State has in the other Contracting State will be considered to be from sources within that other Contracting State. Thus, items of income described in section 864(c)(4)(B) of the Code attributable to a permanent establishment situated in the United States will be subject to tax by the United States. The limited "force of attraction" rule under Code section 864(c)(3) does not apply for U.S. tax purposes under the Convention.

In determining the proper attribution of industrial or commercial profits under the Convention, paragraph (2) provides thrat both Contracting States will attribute to the permanent establishment such profits as it would reasonably be expected to derive if it were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the resident of which it is a permanent establishment. Under paragraph (3), expenses, wherever incurred, which are reasonably connected with profits attributable or apportionable to the permanent establishment, including executive and general administrative expenses, will be allowed as deductions in determining the industrial or commercial profits of the permanent establishment. However, in determining the amount of the deduction under paragraph (3) for expenses incurred by the head office, the deduction generally will be limited to the appropriate share of the expense incurred without including a profit element for the head office.

Paragraph (4) provides that no profits shall be attributed to a permanent establishment merely because of the purchase of goods or merchandise by that permanent establishment, or by the resident of which it is a permanent establishment, for the account of such resident. Paragraph (2) of the article does not override paragraph (4). Thus, where a permanent establishment purchases goods for its head office, the industrial and commercial profits attributed under paragraph (2) to the permanent establishment with respect to its other activities will not be increased by adding a notional figure for profits from purchasing.

Under paragraph (5), the term "industrial or commercial profits" includes income derived from manufacturing, mercantile, banking, insurance, agricultural, fishing or mining activities, the operation of ships or aircraft, the furnishing of services, the rental of tangible personal (movable) property, and the rental or licensing of motion picture films or films or tapes used for radio or television broadcasting. The term does not include income from the performance of personal services derived by an individual either as an employee or in an independent capacity.

Under paragraph (6) of this article, the term "industrial and commercial profits" also includes income from dividends, interest, royalties described in paragraph (2) of Article 13

(Royalties), and capital gains and income derived from property and natural resources, but only if the income is effectively connected with a permanent establishment. See paragraph (4) of Article 11 (Dividends), paragraph (5) of Article 12 (Interest), paragraph (3) of Article 13 (Royalties) and paragraph (1)(c) of Article 14 (Capital Gains).

Paragraph (6) also contains criteria for determining whether income is effectively connected with a permanent establishment. Factors to be taken into account include whether the rights or property giving rise to such income are used in or held for use in carrying on an activity giving rise to industrial or commercial profits through a permanent establishment and whether the activities carried on through such permanent establishment were a material factor in the realization of the income. For this purpose, due regard will be given to whether or not such property or rights or such income were accounted for through such permanent establishment.

Under paragraph (7), where industrial or commercial profits include items of income which are dealt with separately in other articles of the Convention, the provisions of those articles will, except as otherwise provided therein, supersede the provisions of this Article. Thus, for example, taxation of interest income (other than interest treated as income from real property under paragraph (1) of Article 7 (Income from Real Property)) will be controlled by Article 12 (Interest) and not by this Article unless the interest is effectively connected with a permanent establishment.

Article 9. SHIPPING AND AIR TRANSPORT

Paragraph (1) provides that, notwithstanding Article 8 (Business Profits), income derived by a resident of one Contracting State from the operation in international traffic of ships or aircraft, shall be exempt from tax by the other Contracting State. Gains from the sale, exchange, or other disposition of ships or aircraft are dealt with in the general rule of paragraph (1) of Article 14 (Capital Gains).

Under paragraph (2), this article applies to income derived from the rental of such ships or aircraft under a full or bareboat charter if the lessor is engaged in the operation of ships or aircraft in international traffic and the rental income is incidental to such operations of the lessor. For example, if an airline which is a resident of one Contracting State has excess equipment in the winter months and leases several of its aircraft which are not required by it during that period to an airline which is a resident of the other Contracting State, that rental income of the lessor is not subject to tax by the other Contracting State.

Paragraph (2) also makes clear that the article applies to income derived by a resident of one Contracting State from the use, maintenance, and lease of containers, trailers for the inland transportation of containers and other related equipment in connection with the operation by the resident in international traffic of ships or aircraft described in paragraph (1).

Paragraph (2) makes explicit that income derived from the operation in international traffic of ships or aircraft means income derived directly from the operation of ships or aircraft and does not include dividends received by a shareholder in a corporation, where such corporation operates ships or aircraft in international traffic.

This article is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Therefore, a Contracting State may tax income from international traffic derived by a resident of the other Contracting State without regard to this article if such resident is a citizen of the first-mentioned Contracting State.

Paragraph (3) provides that the limited existing exemption of U.S. air transport enterprises afforded by Decree of the Egyptian Council of Ministers of November 23, 1955 shall cease to have effect upon entry into force of this Convention.

Article 10. RELATED PERSONS

This Article complements section 482 of the Code and confirms the authority of the United States under that section. Thus, where a person subject to the taxing jurisdiction of a Contracting State (whether or not a resident thereof) and any other related person make arrangements or impose conditions between themselves which are different from those which would be made between independent persons, under paragraph (1), any income, deductions, credits or allowances which would, but for those arrangements or conditions, have been taken into account in computing the income or loss of, or the tax payable by, one of such persons, may be taken into account in computing the amount of the income subject to tax and the taxes payable by such person in the Contracting State.

Paragraph (2) sets forth an explicit formulation of the consequence of a redetermination made in accordance with paragraph

(1) by a Contracting State to the income of one of its residents. In such event, the other Contracting State will, if it agrees with such redetermination and if necessary to prevent double taxation, make a corresponding adjustment to the income of a person in such other Contracting State related to such resident. If the other Contracting State disagrees with the redetermination, the two Contracting States will endeavor to reach agreement in accordance with the mutual agreement procedure in paragraph (2) of Article 27 (Mutual Agreement Procedure).

Paragraph (3) provides that for purposes of the Convention a person is related to another person if either person owns or controls directly or indirectly the other, or if a third person or persons own or control directly or indirectly both. "Control" includes any kind of control, whether or not legally enforceable, and however exercised or exercisable.

Article 11. DIVIDENDS

Paragraph (1) provides that dividends derived from sources within one Contracting State by a resident of the other Contracting State may be taxed by both Contracting States.

Paragraph (2) limits the rate of tax imposed by the United States to a rate not in excess of fifteen percent of the gross amount of the dividend paid by a United States corporation to an Egyptian resident. However, if the dividend recipient is an Egyptian corporation, the rate of tax imposed by the United States may not exceed five percent of the gross amount of the dividend paid by a United States corporation. This additional rate limitation only applies if during the part of the paying corporation's taxable year which precedes the date of payment of the dividend and during the whole of its prior taxable year (if any), at least ten percent of the outstanding voting stock of the paying corporation was owned by the recipient corporation, and not more than twenty-five percent of the gross income of the paying corporation for such prior taxable year (if any) consists of interest or dividends (other than interest derived from the conduct of a banking, insurance, or financing business and dividends or interest received from subsidiary corporations, fifty percent or more of the outstanding voting stock of which is owned by the paying corporation at the time such dividends or interest is received). These rate limitations do not affect the taxation of profits of the company which pays the dividends.

Paragraph (3) provides that dividends paid by an Egyptian corporation to a resident of the United States will be subject to the following Egyptian taxes (and substantially similar taxes enacted after August 24, 1980) to be deducted at the source: (a) the tax on income derived from movable capital; (b) the defense tax; (c) the national security tax; (d) the war tax; and (e) the supplementary taxes computed on the basis of the previously mentioned taxes (these taxes are hereinafter referred to collectively as "taxes on income from movable capital"). However, to the extent such dividends are distributed out of the current year's earnings, the amount of such dividend will be allowed as a deduction to the corporation in computing its taxable profits subject to the Egyptian taxes on industrial and commercial profits. Dividends paid to a U.S. corporation will not be subject to any other Egyptian taxes.

The rate of the taxes on income from movable capital is essentially the same as that of the taxes on industrial and commercial profits. Thus, double taxation by Egypt is avoided under internal Egyptian law to the extent earnings are distributed currently. Conversely, if current earnings are not distributed, such earnings will be subject to the taxes on industrial and commercial profits in the year earned and to the taxes on income from movable capital in the year distributed.

In the case of dividends paid to a natural person who is a resident of the United States, paragraph (3) provides that Egypt may also impose its graduated general income tax on such dividends in addition to the taxes on income from movable capital. However, in applying these graduated rates, the total general income tax on the dividend income of an individual may not exceed an average of 20 percent of the net dividends. Thus, where the Egyptian taxable income of the individual is so small that the marginal rate applicable to the dividends is less than 20 percent, the tax will fall below the maximum; and where the aggregate income is so large that the marginal rates exceed 20 percent, the higher marginal rates will apply, but only to the point where the average rate of general income tax on the income does not exceed 20 percent.

Paragraph (4) provides that the limitations of paragraphs (2) and (3) will not apply if the dividends are treated, under paragraph (6) of Article 8 (Business Profits), as industrial or commercial profits attributable to a permanent establishment which the recipient has in the source Contracting State. In such case, the provisions of Article 8 (Business Profits) will apply. If the recipient of the dividend is a citizen of the source Contracting State, that Contracting State may tax the recipient without regard to this article because of the saving clause of paragraph (3) of Article 6 (General Rules of Taxation).

Paragraph (5) provides that Egypt may tax dividends paid by a

United States corporation whose activities lie solely or mainly in Egypt as though paid by an Egyptian corporation. Accordingly, dividends paid by such a corporation to United States residents will be taxed in the manner prescribed in paragraph (3) of this Article. Thus, a United States corporation whose activities lie solely or mainly in Egypt, even though its head or administrative office is outside Egypt, will be subject to the Egyptian taxes on industrial and commercial profits computed on its income after deducting the amount of current income distributed as dividends. Such dividends, in turn, will be subject to the taxes on income from movable capital which are deducted at the source; and, by virtue of paragraph (1)(a) of Article 4 (Source of Income), such dividends will be treated as income from sources within Egypt. The factors determining when a foreign company's activities lie solely or mainly in Egypt are not specified in the treaty or in Egyptian statutory law; however, the Egyptian tax authorities take into account such elements as the corporation's charter, balance sheet, and profit and loss statement, and the ratio of profits from sources in Egypt to total profits. In substance, this provision reflects those aspects of internal Egyptian tax law which, in order to avoid discrimination between Egyptian and foreign corporations, treat foreign corporations most of whose activities are conducted through an Egyptian branch as Egyptian corporations for Egyptian tax purposes.

Paragraph (6) applies to the yearly profits attributable to an Egyptian permanent establishment of a United States corporation (other than a United States corporation specified in paragraph (5)) which are deemed distributed currently as a dividend in accordance with the provisions of Egyptian taxation law. These dividends deemed paid will be deductible for purposes of computing the income subject to the taxes on industrial and commercial profits and hence they will be subject only to the Egyptian taxes specified in paragraph (3).

Paragraph (7) defines the term "dividends" to mean income from shares and similar rights, which are not debt claims and which participate in profits. The term includes income from other corporate rights which is treated as income from shares under the taxation laws of the State of residence of the corporation making the distribution. Each Contracting State may apply its domestic law rules for differentiating dividends from interest and other disbursements, subject to an agreement between the competent authorities as to a common meaning. See paragraph (2) of Article 2 (General Difinitions).

Article 12. INTEREST

Paragraph (1) provides that interest derived by a resident of one Contracting State from sources within the other Contracting State may be taxed by both Contracting States. However, paragraph (2) limits the rate of tax in the Contracting State of source to a rate not in excess of 15 percent of the gross amount of the interest.

Paragraph (3) provides that interest beneficially derived by one of the Contracting States, or by an instrumentality of that Contracting State not subject to tax by that Contracting State on its income, will be exempt from tax by the other Contracting State. Under this rule, interest income derived by the Export-Import Bank of the United States and the Overseas Private Investment Corporation (OPIC) on loans made to Egyptian residents will be exempt from tax in Egypt. The exemption also applies where a resident of a Contracting State receives interest income with respect to debt obligations made, guaranteed or insured by that Contracting State or an instrumentality thereof.

Paragraph (4) provides that interest paid by a resident of one Contracting State to a person other than a resident of the other Contracting State (and in the case of interest paid by a resident of Egypt, to a person other than a United States citizen) will be exempt from tax by the other Contracting State unless such interest is treated as income from sources within the other Contracting State under paragraph (2) of Article 4 (Source of Income).

Paragraph (5) provides that the limitations of paragraphs (2), (3) and (4) will not apply if the interest is treated, under paragraph (6) of Article 8 (Business Profits), as industrial or commercial profits attributable to a permanent establishment which the recipient has in the source Contracting State. In such a case, the provisions of Article 8 (Business Profits) will apply.

If excessive interest is paid to a related person, paragraph (6) provides that the article does not apply to the excessive portion of the payment. The excessive portion may be taxed by each Contracting State according to its own laws, including the Convention, where applicable. In the case of the United States, the excessive portion may be taxed as a dividend, in which case the provisions of Article 11 (Dividends) will apply.

Paragraph (7) defines interest for purposes of the Convention as income from money lent and other income which under the taxation law of the Contracting State in which the income has its source is assimilated to income from money lent. However, the term "interest" does not include interest on indebtedness secured by mortgages on real estate or other amounts considered income from real property under Article 7 (Income from Real Property) and to which the provisions of Article 7 apply.

This Article is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Therefore, interest derived by a citizen of the source Contracting State may be taxed by that Contracting State without regard to this Article.

Article 13. ROYALTIES

Paragraph (1) provides that royalties derived by a resident of one Contracting State from sources within the other Contracting State may be taxed by both Contracting States. However, paragraph (1) limits the tax in that other Contracting State to a rate not to exceed 15 percent of the gross amount of such royalty.

The term "royalties" is defined in paragraph (2) as payments of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, or scientific works (but not including copyrights of motion picture films or films or tapes used for radio or television broadcasting which are industrial and commercial profits within the meaning of paragraph (5) of Article 8 (Business Profits)), and patents, designs, models, plans, secret processes or formulae, trademarks, or other like property or rights. The term "royalties" also includes gains derived from the sale, exchange, or other disposition of such property or rights to the extent the amounts realized on such sale, exchange or other disposition for consideration are contingent on the productivity, use, or disposition of the property or rights. If the amounts realized are not so contingent, the provisions of Article 14 (Capital Gains) may apply.

Paragraph (3) provides that the tax rate limitations of paragraph (1) shall not apply if the royalty is treated, under paragraph (6) of Article 8 (Business Profits), as industrial or commercial profits attributable to a permanent establishment which the recipient, a resident of one Contracting State, has in the other Contracting State. In such a case, the provisions of Article 8 will apply.

Paragraph (4) provides that this article will not apply to dividends paid on founders' shares issued in Egypt as consideration for the rights mentioned in paragraph (2) of this Article and which are taxed in Egypt in accordance with the provisions of

Article 1 of Law No. 14 of 1939. In such case, the provisions of Article 11 (Dividends) will apply.

If excessive royalties are paid to a related person, paragraph (5) provides that the Article does not apply to the excessive portion of the royalty. The excessive portion may be taxed by each Contracting State according to its own laws, including the Convention where applicable. Thus, in the case of the United States, the excessive portion may be treated as a dividend or interest, or in whatever other manner is appropriate.

As noted under paragraph (3) of Article 4 (Source of Income), royalties (including contingent gains) will be treated as income from sources within a Contracting State only to the extent they are payments made as consideration for the use of, or the right to use, property or rights described in paragraph (2) within that Contracting State. This source rule is similar to the source rule in section 861(a)(4) of the Code.

This article is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Therefore, royalties derived by a citizen of the source Contracting State may be taxed by that Contracting State without regard to this article.

Article 14. CAPITAL GAINS

Under paragraph (1), a resident of one Contracting State will be exempt from tax by the other Contracting State on gains from the sale, exchange, or other disposition of capital assets. However, the exemption does not apply if (1) the gain is from the sale, exchange or other disposition of property described in Article 7 (Income from Real Property) situated within the other Contracting State; (b) the gain is from the sale, exchange or other disposition of property described in paragraph (2)(b) of Article 13 (Royalties); (c) the gain is treated, under paragraph (6) of Article 8 (Business Profits), as industrial or commercial profits attributable to a permanent establishment which the recipient has in the other Contracting State; or (d) the gain is realized by an individual resident of one Contracting State who is present in the other Contracting State for a period or periods aggregating 183 days or more during the taxable year. For purposes of this Article and the other physical presence tests contained in the Convention with regard to an individual, the term "day" means a calendar day during any portion of which the individual is physically present in the relevant Contracting State.

Paragraph (2) provides that the provisions of Article 7

(Income from Real Property) will apply to real property gains; the provisions of Article 13 (Royalties) will apply to certain royalty gains; and the provisions of Article 8 (Business Profits) will apply to gains attributable to a permanent establishment.

If the recipient of the gain is a resident of one Contracting State and a citizen of the other Contracting State, that other Contracting State may tax the recipient without regard to this Article because of the saving clause of paragraph (3) of Article 6 (General Rules of Taxation).

Article 15. INDEPENDENT PERSONAL SERVICES

In dealing with the taxation of income from personal services the Convention distinguishes between "independent" and "dependent" personal services. The Convention also provides special treatment for individuals who are "public entertainers" and for amounts received for furnishing the personal services of others.

Under paragraph (1), income derived by an individual resident of one Contracting State from the performance of personal services in an independent capacity may be taxed only by that Contracting State. However, under paragraph (2), such income derived from services performed in the other Contracting State may also be subject to tax in that other Contracting State if the individual is present therein for a period or periods aggregating 90 days or more in the taxable year. Under the saving clause of paragraph (3) of Article 6 (General Rules of Taxation), the other Contracting State may also tax any individual who is a citizen of that other Contracting State without regard to this Article.

Services performed by an individual in an independent capacity are services performed for his own account where he receives the income and bears the losses arising from such services. Generally, as noted in paragraph (3), the term "personal services in an independent capacity" includes but is not limited to, scientific, literary, artistic, educational, or teaching activities as well as services rendered by physicians, lawyers, engineers, architects, dentists and accountants performing personal services.

Article 16. DEPENDENT PERSONAL SERVICES

Under paragraph (1), wages, salaries, and similar remuneration derived by an individual who is a resident of one Contracting State from labor or personal services performed as an employee, including income from services performed by an officer of a corporation or company, may be taxed by that Contracting State, except as provided in Articles 21 (Governmental Functions), 22 (Teachers), and 23 (Students and Trainees). In addition, except as provided by paragraph (2) and Articles 19 (Private Pensions and Annuities), 21 (Governmental Functions), 22 (Teachers), and 23 (Students and Trainees), such remuneration derived from sources within the other Contracting State may be taxed by that other Contracting State.

Under paragraph (2), dependent personal service income derived by an individual resident of one Contracting State will be exempt from tax by the other Contracting State if: (a) the individual is present in that other Contracting State for a period or periods aggregating less than 90 days in the taxable year; (b) the individual is an employee of a resident of the first-mentioned Contracting State or of a permanent establishment maintained in the first-mentioned Contracting State; (c) the remuneration is not borne as such (i.e., as a deduction for salary payments) by a permanent establishment which the employer has in the other Contracting State; and (d) the remuneration is subject to tax in the first-mentioned Contracting State. Income of a United States citizen or resident which is excluded from tax by reason of section 911 is not considered subject to tax by the United States. Dependent personal service income may also be taxed by that other Contracting State without regard to this article if the individual is a citizen of that other Contracting State, because of the saving clause of paragraph (3) of Article 6 (General Rules of Taxation).

Under paragraph (3), and notwithstanding paragraphs (1) and (2), remuneration derived by an employee (even if a resident of a State other than a Contracting State) of a resident of one Contracting State for labor or personal services performed as a member of the regular complement of a ship or aircraft operated in international traffic by a resident of that Contracting State may be taxed by that Contracting State.

Article 17. PUBLIC ENTERTAINERS

This Article provides that, notwithstanding Articles 15 (Independent Personal Services) and 16 (Dependent Personal Services), income derived by an individual resident of one Contracting State from his performance of personal services in the other Contracting State as a public entertainer, such as a theater, motion picture, radio or television artist, a musician, or athlete, may be taxed by the other Contracting State only if the gross amount of such income exceeds $400 or its equivalent in Egyptian pounds for each day the individual is present in the other Contracting State for the purpose of performing such services therein. If the entertainers's gross income exceeds $400 per day he may be taxed on the full amount of his income, not just the amount in excess of $400.

If the individual receives a fixed amount for performing the services on more than one day, the amount received will be prorated over the number of days the individual performs the services. Thus, for example, if an entertainer resident in Egypt receives $5,000 to perform in a series of 5 concerts in the United States on 5 different days and spends an additional 5 days in the United States in rehearsal for those concerts over a two week period, he will be considered to have received $500 for each day and thus, pursuant to this Article, he may be taxed by the United States.

Income derived from services rendered by producers, directors, technicians, and others who are not public entertainers is taxable in accordance with the provisions of Article 15 (Independent Personal Services), or Article 16 (Dependent Personal Services), as the case may be.

Under the saving clause of paragraph (3) of Article 6 (General Rules of Taxation), if the individual is a citizen of a Contracting State that State may tax his income without regard to this Article.

Article 18. AMOUNTS RECEIVED FOR FURNISHING PERSONAL SERVICES OF OTHERS

Paragraph (1) provides that, notwithstanding the provisions of Article 8 (Business Profits), amounts received by a resident of one Contracting State in consideration of furnishing in the other Contracting State the personal services of one or more other persons, including a public entertainer referred to in Article 17 (Public Entertainers), may be subject to tax under the taxation laws of each Contracting State to the extent that the person for whom the services were furnished designated the person or persons who would render the services, whether or not he had the legal right to do so and whether or not the designation was made formally; the person for whom the services were furnished had the right to designate the person or persons who would render the services; or, by reason of the facts and circumstances, the arrangement for personal services had the effect of designating the person or persons who would render the services; and the resident of the first-mentioned Contracting State directly or indirectly pays compensation for such services to any person, other than another resident of the first-mentioned Contracting

State or of that other Contracting State who is subject to tax on such compensation. If this paragraph applies, the amounts received for providing personal services of other individuals in the other Contracting State may be taxed by that other Contracting State even though not attributable to a permanent establishment.

Paragraph (2) provides that paragraph (1) will not apply if it is established to the satisfaction of the competent authority of that other Contracting State with respect to any amount received that neither the creation nor organization of the resident of the first-mentioned Contracting State (where such resident is a corporation or other entity) nor the furnishing of the services through such resident has the effect of a substantial reduction in income, war profits, excess profits, or similar taxes. The taxes referred to in the preceding sentence are those enumerated in Article 1 (Taxes Covered) which are imposed by the two Contracting States.

Article 19. PRIVATE PENSIONS AND ANNUITIES

Except as provided in Article 21 (Governmental Functions), pensions and other similar remuneration paid to an individual will be taxable under paragraph (1) only in the Contracting State of which he is a resident. Thus, private pensions and similar remuneration derived from sources within one Contracting State by an individual resident of the other Contracting State are exempt from tax in the first-mentioned Contracting State. Pensions for Government service are dealt with in Article 21 (Governmental Functions). The term "pensions and other similar remuneration" is defined in paragraph (4) as periodic payments, other than social security payments covered in Article 20 (Social Security Payments), made by reason of retirement or death and in consideration for services rendered, or by way of compensation for injuries or sickness received in connection with past employment.

Paragraph (2) provides that alimony and annuities paid to an individual resident of a Contracting State will be taxable only in that Contracting State. The term "annuities" is defined in paragraph (5) as a stated sum paid periodically at stated times during life, or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than for services rendered). The term "alimony" is defined in paragraph (6) as periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support which are taxable to the recipient under the internal laws of the

Contracting State of which he is a resident. Thus, the term "alimony" would not include a payment which would not be taxable to the recipient under the laws of the Contracting State in which he is resident even though such payment is made pursuant to a decree of divorce or of separate maintenance.

Paragraph (3) provides that child support payments made by an individual resident of one Contracting State to an individual resident of the other Contracting State will be exempt from tax in that other Contracting State. The term "child support payments" is defined in paragraph (7) as periodic payments for the support of a minor child made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support.

Except for paragraph (3), dealing with child support, this article is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Therefore, individuals who are citizens or residents of a Contracting State may be taxed by that Contracting State without regard to this article.

Article 20. SOCIAL SECURITY PAYMENTS

This article provides that social security payments and other public pensions, e.g., railroad retirement benefits, paid by one Contracting State to an individual who is a resident of the other Contracting State shall be taxable only in that other Contracting State. Payments described in Article 21 (Governmental Functions) are not covered by this article.

Under paragraph (2) of Article 32 (Termination), this article may be terminated by either Contracting State at any time after the Convention enters into force.

Under paragraph (4)(a) of Article 6 (General Rules of Taxation), the saving clause of paragraph (3) of Article 6 does not apply to the provisions of this Article. Thus, the exemption applies even to a citizen of a Contracting State.

Article 21. GOVERNMENTAL FUNCTIONS

Under paragraph (1) of this Article, wages, salaries, or similar remuneration, including pensions, annuities, or similar benefits, paid from public funds of one Contracting State to a citizen of that Contracting State, or to a citizen of a State other than a Contracting State who comes to the other Contracting State expressly for the purpose of being employed by the first-mentioned Contracting State, for labor or personal services performed as an employee of the national Government of that Contracting State, or any agency thereof, in the discharge of functions of a governmental nature will be exempt from tax by the other Contracting State. If the individual becomes a citizen of, or acquires immigrant status in, the other Contracting State, that other Contracting State may tax the individual without regard to this article. See paragraphs (3) and (4)(b) of Article 6 (General Rules of Taxation).

Whether services will be treated as performed in the discharge of governmental functions may be determined by reference to the concept of a governmental function in the State in which the income arises. Thus, as provided in paragraph (2), remuneration or pensions paid in respect of services rendered in connection with any trade or business carried on by one of the Contracting States or any agency thereof will be treated the same as compensation received from a private employer, and the provisions of Articles 16 (Dependent Personal Services) and 19 (Private Pensions and Annuities) will apply.

This Article applies only to remuneration paid by the national Government or agencies of the national Government of a Contracting State.

Article 22. TEACHERS

Paragraph (1) provides that, if a resident of one Contracting State is invited by the other Contracting State, a political subdivision or local authority thereof, or by a university or other recognized educational institution in that other Contracting State to come to that other Contracting State for a period not expected to exceed two years for the purpose of teaching or engaging in research, or both, at a university or other recognized educational institution, and if such resident comes to that other Contracting State primarily for such purpose, his income from personal services for teaching or research at such university or educational institution will be exempt from tax by that other Contracting State for a period not exceeding two years from the date of his arrival in that other Contracting State.

Since a temporary visit may be of such a duration that an individual may lose his status as a resident of the Contracting State of which he was a resident at the time he became eligible for the benefits of this article, the individual need only be a resident of such Contracting State at the beginning of his visit. However, if the individual becomes a citizen of, or acquires immigrant status in, the other Contracting State, that other

Contracting State may tax the individual without regard to this article. See paragraphs (3) and (4)(b) of Article 6 (General Rules of Taxation). If the individual's visit exceeds a period of two years from the date of his arrival, the exemption applies only to the income received by the individual before the expiration of such two year period.

Pursuant to paragraph (2), this article does not apply to income from research undertaken not in the public interest but primarily for the private benefit of a specific person or persons other than the person performing the research.

Article 23. STUDENTS AND TRAINEES

Paragraph (1) provides that an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein for the primary purpose of studying at a university or other recognized educational institution, securing training required to qualify him to practice a profession or professional speciality, or studying or doing research as a recipient of a grant, allowance, or award from a governmental, religious, charitable, scientific, literary, or educational organization, will be exempt from tax by that other Contracting State for a period not exceeding five taxable years from the date of his arrival in that other Contracting State and for such additional period of time as is necessary to complete, as a full-time student, the educational requirements as a candidate for a post-graduate or professional degree from a recognized educational institution on:

(1) gifts from abroad for the purpose of his maintenance, education, study, research, or training;

(2) the grant, allowance, or award; and

(3) income from personal services performed in the other Contracting State not in excess of $3,000 or its equivalent in Egyptian pounds for any taxable year.

Under paragraph (2), an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein as an employee of, or under contract with, a resident of the first-mentioned Contracting State, for the primary purpose of acquiring technical, professional, or business experience from a person other than that resident of the first-mentioned Contracting State or other than a person related to such resident, or studying at a university or other recognized educational institution in that other Contracting State, will be exempt from tax by that other Contracting State for a period not exceeding twelve consecutive months, on income from personal services not in excess of $7,500 or its equivalent in Egyptian pounds.

Under paragraph (3), an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein for a period not exceeding one year, as a participant in a program sponsored by the other Contracting State, for the primary purpose of training, research, or study, will be exempt from tax by the other Contracting State with respect to his income from personal services in respect of such training, research, or study performed in that other Contracting State in an aggregate amount not in excess of $10,000 or its equivalent in Egyptian pounds.

The monetary limits provided in paragraphs (1), (2), or (3) are in addition to, and not in lieu of, other exemptions provided by the Code. Thus, an unmarried resident of Egypt who is temporarily present in the United States for the primary purpose of studying at a university would be entitled to exclude $3,000 of income from the performance of personal services and, in addition, would be entitled to the personal exemption allowed by section 151 of the Code, as provided in section 873(b) of the Code.

The first sentence of paragraph (4) provides that the benefits provided in paragraph (1) and the benefits provided under Article 22 (Teachers), when taken together, may extend only for such period of time, not to exceed five taxable years from the date of the individual's arrival, as may reasonably or customarily be required to effectuate the purpose of the visit, and for such additional period of time as is specified in paragraph (1). The second sentence of paragraph (4) makes it clear that the benefits provided by Article 22 will not be available to an individual if, during the immediately preceding period, the individual enjoyed the benefits provided by paragraph (1). Thus, an Egyptian individual who originally entered the United States for the purpose of becoming a student and received benefits under paragraph (1) must leave the United States and, if necessary, reestablish residence in Egypt, and then return at the invitation of the United States, a political subdivision or local authority thereof, or a university or other recognized educational institution for the primary purpose of becoming a teacher in order to take advantage of Article 22.

If an individual qualifies for the benefits of more than one of the provisions of Article 22 (Teachers) and this Article, such individual may choose the most favorable provision, but may not claim the benefits of more than one provision in any taxable year as a means of avoiding the limitations provided. Thus, for example, an individual who comes to the other Contracting State for the primary purpose of studying may be able to qualify under either paragraphs (2) or (3) of this Article. However, he cannot combine the maximum exclusion limits in those two paragraphs to exclude $17,500 during the taxable year. If the individual becomes a citizen of, or acquires immigrant status in, the other Contracting State, that other Contracting State may tax the individual without regard to this Article. See paragraphs (3) and (4)(b) of Article 6 (General Rules of Taxation).

Article 24. INVESTMENT OR HOLDING COMPANIES

The article provides that a corporation of one Contracting State deriving dividends, interest, royalties or capital gains from sources within the other Contracting State will not be entitled to the benefits of Articles 11 (Dividends), 12 (Interest), 13 (Royalties) or 14 (Capital Gains) if, by reason of special measures, the tax imposed on such corporation by the first-mentioned Contracting State with respect to such dividends, interest, royalties or capital gains is substantially less than the tax generally imposed by such Contracting State on corporate profits, and twenty-five percent or more of the capital of such corporation is held of record or is otherwise determined, after consultation between the competent authorities of the Contracting States, to be owned, directly or indirectly, by one or more persons who are not individual residents of the first-mentioned Contracting State (or, in the case of an Egyptian corporation, who are citizens of the United States). For purposes of applying this Article, it is intended that the requisite direct or indirect ownership be tested at the individual shareholder level. Existing Code provisions dealing with the taxation of capital gains do not make this article applicable with respect to capital gains.

The purpose of this Article is to deal with potential abuse which could occur if one of the Contracting States provided preferential rates of tax for investment or holding companies. In the absence of this Article, residents of third countries could organize a corporation in the Contracting State extending the preferential rates for the purpose of making investments in the other Contracting State. The combination of low tax rates in the first-mentioned Contracting State and the reduced rates or exemptions in the other Contracting State would enable the third country residents to realize unintended benefits.

Article 25. RELIEF FROM DOUBLE TAXATION

In order to avoid double taxation, each Contracting State agrees in this Article to provide to its citizens or residents a credit against its taxes for taxes paid by such persons to the other Contracting State.

In paragraph (1), the United States agrees to allow a United States citizen or resident as a credit against United States tax an appropriate amount of taxes paid or accrued to Egypt in accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle of paragraph (1)). In addition, in the case of a United States corporation owning at least ten percent of the voting stock of an Egyptian corporation from which it receives dividends in any taxable year, the United States will allow a credit for the appropriate amount of taxes paid or accrued to Egypt by the Egyptian corporation paying such dividends with respect to the profits out of which such dividends are paid. The appropriate amount will be based upon the amount of tax paid or accrued to Egypt, but the credit is not to exceed the limitations (for the purpose of limiting the credit to the United States tax on income from sources within Egypt or on income from sources outside the United States) provided by United States law for the taxable year. This provision does not require the United States to maintain a per-country or overall limitation in the future so long as the general principle of a foreign tax credit remains in effect. For the purpose of applying the United States credit in relation to taxes paid or accrued to Egypt, the rules set forth in Article 4 (Source of Income) will be applied to determine the source of income, and the taxes referred to in paragraphs (1)(b) and (2) of Article 1 (Taxes Covered) will be considered to be income taxes. Whether Egyptian taxes are paid or accrued is determined under the rules of the Code. A taxpayer may, for any year, claim a foreign tax credit under the rules of the Code. In that case, he would forego the rules of the Convention that guarantee income tax status for the specified Egyptian taxes.

Under paragraph (2), Egypt will allow a resident of Egypt as a credit against Egyptian tax the appropriate amount of income taxes paid or accrued to the United States and, in the case of an Egyptian corporation owning at least ten percent of the voting stock of a United States corporation from which it receives dividends in any taxable year, will also allow credit for the appropriate amount of taxes paid or accrued to the United States by the United States corporation paying such dividends with respect to the profits out of which such dividends are paid. The appropriate amount will be based upon the amount of tax paid or accrued to the United States but will not exceed that portion of Egyptian tax which such resident's net income from sources within the United States bears to his entire net income for the same taxable year. For the purpose of applying the Egyptian credit in relation to taxes paid or accrued to the United States, the rules set forth in Article 4 (Source of Income) will be applied to determine the source of income.

Paragraph (4) of Article 6 (General Rules of Taxation) provides that the saving clause in paragraph (3) of that Article does not affect the benefits conferred under this Article. Thus, the provisions of this Article may be relied upon by a citizen or resident of a Contracting State.

Article 26. NONDISCRIMINATION

Paragraph (1) provides that a citizen of one Contracting State who is a resident of the other Contracting State will not be subject in that other Contracting State to more burdensome taxes than a citizen of that other Contracting State who is a resident thereof. The determination of whether there is more burdensome taxation is to be made by comparing the treatment of individuals who are in comparable positions. Thus, for example, a citizen of Egypt who is a resident of the United States and who otherwise meets the requirements specified in section 911 of the Code would, under this Article, be eligible for the benefits of section 911 even though not a citizen of the United States.

Paragraph (2) provides that a permanent establishment which a resident of one Contracting State has in the other Contracting State will not be subject in that other Contracting State to more burdensome taxes than a resident of that other Contracting State carrying on the same activities. However, as noted in paragraph (2)(a), this does not obligate a Contracting State to grant to individual residents of the other Contracting State any personal allowances, reliefs, or deductions for taxation purposes on account of civil status or family responsibilities which it grants its own individual residents.

Under paragraph (2)(b) Egypt is not obliged to grant United States corporations the exemptions granted Egyptian corporations under Articles 5 and 6 of Law No. 14 of 1939. Article 5 of that law exempts from Egyptian tax certain foreign source investment income which an Egyptian insurance company earns on reserves which are required under foreign law to be deposited in a foreign country. Article 6 of that law exempts certain distributions to shareholders of Egyptian investment companies, where the investment company has paid tax on its dividend and interest income.

Paragraph (2)(c) preserves the rules of the first and second paragraphs of Article 11 and Article 11 bis of Law No. 14 of 1939. Under these provisions of Egyptian law, the Egyptian branch profits of a foreign corporation are deemed to be distributed and are treated as dividends. Thus, a branch of a foreign corporation is subject to tax on deemed distribution, while an Egyptian corporation is not, because the actual tax on the Egyptian corporation's dividends falls on the recipient and not on the paying corporation. Paragraphs (5) and (6) of Article 11 (Dividends) provide for this treatment. Paragraph (2)(c) of this Article confirms that this treatment will not be considered discriminatory.

Paragraph (3) prohibits one Contracting State from subjecting a corporation of such Contracting State, the capital of which is wholly or partly owned, directly or indirectly, by one or more residents of the other Contracting State to any taxation or any requirement connected with taxation which is other or more burdensome than those applicable to corporations of the first-mentioned Contracting State carrying on the same activities, the capital of which is wholly or partly owned or controlled by one or more residents of the first-mentioned Contracting State.

The provisions of this Article do not override the right of the United States to impose the tax provided in Code section 897 (relating to gains derived by nonresident aliens or foreign corporations from U.S. real property interests).

Under paragraph (3) of Article 1 (Taxes Covered), the provisions of this Article extend to all taxes of every kind imposed at the national, state or local level.

The saving clause in paragraph (3) of Article 6 (General Rules of Taxation) does not apply to this Article. Thus, a Contracting State may not deny any rights conferred by this Article to its citizens and residents.

Article 27. MUTUAL AGREEMENT PROCEDURE

Under paragraph (1), when a resident or citizen of one Contracting State considers that action of one or both Contracting States results or will result for him in taxation not in accordance with the Convention, he may, notwithstanding the remedies provided by the national laws of the Contracting States, present his case to the competent authority of the Contracting State of which he is a resident or citizen. A resident or citizen of a Contracting State need not, although it is anticipated that in the normal situation he will, exhaust his other administrative or judicial remedies prior to resorting to the use of the mutual agreement procedure. If the claim is considered to have merit by the competent authority, that competent authority will endeavor to come to an agreement with the competent authority of the other Contracting State with a view to the avoidance of taxation not in accordance with the Convention.

Paragraph (2) requires the competent authorities of the two Contracting States to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the application of the Convention. In particular, the competent authorities may agree to the same attribution of industrial or commercial profits to a resident of one Contracting State and its permanent establishment situated in the other Contracting State; the same allocation of income, deductions, credits, or allowances between a resident of one Contracting State and a related person and to the readjustment of taxes imposed by each Contracting State to reflect such allocation; the same determination of the source of particular items of income; and the same characterization of particular items of income. The list of subjects of potential mutual agreement in paragraph (2) is not exhaustive; it merely illustrates the principles set forth in the paragraph.

Under paragraph (3), in implementing the provisions of this article, the competent authorities may communicate with each other directly and, when advisable, meet together for an oral exchange of opinions.

Under paragraph (4), in cases in which the competent authorities reach an agreement, taxes will be imposed on such income, and refund or credit of taxes allowed, by the Contracting States in accordance with such agreement. This permits the issuance of a refund or credit notwithstanding procedural barriers otherwise existing under a Contracting State's law, such as the statute of limitations. However, it does not authorize imposition of additional taxes after the statute of limitations has run.

Article 28. EXCHANGE OF INFORMATION

Paragraph (1) provides for a system of administrative cooperation between the competent authorities of the two Contracting States by requiring an exchange of information necessary for the carrying out of the Convention and of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is in accordance with the Convention. Under paragraph (3) of Article 1 (Taxes Covered), the provisions of this article extend to all taxes of every kind imposed at the national level. The competent authorities may exchange information in connection with tax compliance generally, not merely illegal acts or crimes. Information need be exchanged, however, only if it is of a class that can be obtained under the laws and administrative practices of each Contracting State with respect to its own taxes.

Paragraph (2) provides that information exchanged must be treated as secret. However, such information may be disclosed to any persons or authorities concerned with or made part of the public record with respect to the assessment, collection, or enforcement of, or litigation with respect to, the taxes which are the subject of the Convention. Thus, disclosure is not prohibited as a part of a public proceeding before a court or an administrative body.

Paragraph (3) provides that no information may be exchanged which would be contrary to the public policy.

Paragraph (4) provides that depositions of witnesses and copies of unedited original documents (including books, papers, statements, records, accounts, or writings) shall be provided by the competent authority of a Contracting State, if specifically requested by the competent authority of the other Contracting State, to the extent such depositions and documents can be obtained under the laws and administrative practices of each Contracting State with respect to its own taxes.

Paragraph (5) provides that any depositions and evidence which may be furnished in accordance with this article should not be withheld by reason of any doctrine of law under which international judicial assistance is not accorded in tax matters.

Paragraph (6) provides that the exchange of information may be on either a routine basis or on request with reference to particular cases, and that the competent authorities may agree on the list of information to be furnished on a routine basis.

In making the determinations necessary under paragraphs (1) and (4) of this Article, a Contracting State will use the standards it uses in the enforcement of its own laws by its administrative and judicial authorities, treating the tax of the Contracting State with respect to which a request relates as if it were a tax of the Contracting State requested to furnish the information and were being imposed by such Contracting State.

Article 29. ASSISTANCE IN COLLECTION

Paragraph (1) provides that one Contracting State will give the other Contracting State limited assistance in collecting its taxes. Thus, each Contracting State is required to collect on behalf of the other Contracting State only those taxes imposed by such other Contracting State as will ensure that any exemption or reduced rate of tax granted under this Convention by such other Contracting State is not enjoyed by persons not entitled to such benefits.

Paragraph (2) makes clear that a Contracting State is not obligated to carry out measures at variance with the laws or the administrative practice of either Contracting State with respect to the collection of its own taxes.

Article 30. DIPLOMATIC AND CONSULAR OFFICERS

This Article provides that nothing in the Convention will affect the fiscal privileges of diplomatic and consular officials under the general rules of international law or under the provisions of special agreements.

Article 31. ENTRY INTO FORCE

This Article provides that the Convention is subject to ratification and provides for the exchange of instruments of ratification. The Convention will enter into force thirty days after the date of exchange of such instruments of ratification. The Convention shall first have effect as respects the rate of withholding tax, to amounts paid on or after the first day of the second month following the date on which the Convention enters into force, and, as respects other taxes, to taxable years beginning on or after January 1 of the year following the date on which the Convention enters into force.

Article 32. TERMINATION

Paragraph (1) provides that the Convention will continue in force indefinitely, but that it may be terminated by either Contracting State at any time after five years from the date it enters into force. A Contracting State seeking to terminate the Convention must give at least six months' notice through diplomatic channels. If the Convention is terminated, such termination will be effective with respect to income of calendar years or taxable years beginning (or, in the cases of taxes payable at source, payments made) on or after January 1 next following the expiration of the six month period. It is intended that the reference to calendar years applies only to cases where the taxable year is the calendar year.

Under paragraph (2), the provisions of Article 20 (Social Security Payments) may be terminated by either Contracting State at any time after the Convention enters into force by prior notice given through diplomatic channels.

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TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE STATE OF ISRAEL WITH RESPECT TO TAXES ON INCOME, SIGNED AT WASHINGTON, D.C. ON NOVEMBER 20, 1975, AS AMENDED BY A PROTOCOL SIGNED AT WASHINGTON, D.C. ON MAY 30, 1980

INTRODUCTION

This is a technical explanation of the Convention between the United States and Israel, signed on November 20, 1975, as amended by a Protocol signed on May 30, 1980, ("the Convention"). This explanation is an official guide to the Convention. It reflects policies behind particular Convention provisions, as well as understandings reached with respect to the interpretation and application of the Convention.

Article 1. TAXES COVERED

Paragraph (1) designates the taxes of the Contracting States which are the subject of the Convention. With respect to the United States, the subject taxes are the Federal income taxes imposed by the Internal Revenue Code ("Code"). The Convention also applies to the excise tax on insurance premiums paid to foreign insurers, under section 4371 of the Code. However, the excise tax on insurance premiums is covered only to the extent that the foreign insurer does not reinsure the risks, directly or indirectly, with a person who is not entitled to exemption from such tax under this or another United States tax convention. This limitation on coverage is intended to clarify that persons not entitled to the benefits of this or another convention may not use an insurer in Israel as a conduit for the purpose of obtaining convention benefits. Moreover, as provided by paragraph (5) of Article 6 (General Rules of Taxation), the United States reserves the right to impose taxes under Code sections 531 (accumulated earnings tax) and 541 (personal holding company tax), except as provided in such paragraph (5).

United States taxes not generally covered by the Convention include the estate, gift and generation skipping transfer taxes, the Windfall Profits Tax, Federal unemployment taxes and social security taxes imposed under sections 1401, 3101 and 3111 of the Code.

In the case of Israel, paragraph (1) provides that the Convention applies to the income tax (including capital gains tax); the company tax; the tax on gains from the sale of land under the land appreciation tax law; the tax on profits levied on banking institutions and insurance companies under the Value Added Tax Law; and compulsory loans made with respect to taxable years ending before April 1, 1988, with respect to corporations that became subject thereto before April 1, 1977. This reflects the fact that compulsory loans are being phased-out from Israeli law. See the discussion of Article 26 (Relief from Double Taxation) for an analysis of the treatment of these compulsory loans for purposes of the United States foreign tax credit.

Pursuant to paragraph (2), the Convention will also apply to taxes substantially similar to those covered by paragraph (1) which are imposed in addition to, or in place of, existing income taxes, after November 20, 1975 (the date of signature of the Convention).

Under paragraph (3), for purposes of Article 27 (Nondiscrimination), the Convention applies to taxes of every kind imposed at the national level.

Paragraph (4) provides that the competent authority of each Contracting State will notify the competent authority of the other Contracting State of any substantial amendment of the tax laws referred to in paragraph (1), or of the adoption of substantially similar taxes imposed in addition to, or in place of, those taxes by transmitting the texts of such amendments or statutes. Paragraph (5) provides for a similar exchange with respect to the publication of material concerning the application of the Convention, whether in the form of regulations, rulings or judicial decisions.

Article 2. GENERAL DEFINITIONS

Paragraph (1) sets out definitions of certain basic terms used in the Convention. Unless the context otherwise requires, the terms defined in this paragraph have a uniform meaning throughout the Convention. A number of important terms, however, are defined elsewhere in the Convention.

The term "United States" means the United States of America. When used in a geographical sense, the term means the states of the United States and the District of Columbia. Thus, the Convention does not apply to the possessions of the United States or the Commonwealth of Puerto Rico. The term "Israel" means the State of Israel.

When used in a geographical sense, the terms "United States" and "Israel" also include their respective territorial seas, and in general accord with the principles of section 638 of the Code, their respective continental shelves.

The term "Contracting State" is defined to mean the United States or Israel as the context requires. The term "State" means the United States, Israel, or any other national State.

The term "person" is defined as including an individual, a partnership, a corporation, an estate or a trust.

The term "United States corporation" is defined as a corporation, or any unincorporated entity which is treated as a corporation for United States tax purposes, which is created or organized under the laws of the United States, any state thereof, or the District of Columbia. An "Israeli corporation" is defined as any body of persons taxed as a body of persons resident in Israel under its income tax ordinance. Thus, for example, a corporation incorporated in a State other than a Contracting State which is taxed by Israel as a body of persons resident in Israel will be an Israeli corporation for purposes of the Convention. See, however, the discussion of paragraph (3) of Article 3 (Fiscal Residence) for the treatment of a corporation which is both resident of the United States and a resident of Israel.

With respect to the United States, the term "competent authority" means the Secretary of the Treasury or his delegate. With respect to Israel, it means the Minister of Finance or his delegate. The term "tax" means those taxes imposed by the United States or Israel to which the Convention applies by virtue of Article 1 (Taxes Covered).

The term "international traffic" is defined as any voyage of a ship or aircraft operated by a resident of one of the Contracting States except where such voyage is confined solely to places within a Contracting State. Thus, for example, coastal shipping along the Atlantic coast of the United States is not a voyage in international traffic. However, if a ship operated by a resident of Israel transports goods from Canada to the United States, leaving some of the goods in New York and the remainder in Norfolk, the portion of the voyage between New York and Norfolk is international traffic.

Paragraph (2) provides that any term used in the Convention which is not defined therein shall, unless the context otherwise requires, have the meaning which it has under the laws of the Contracting State whose tax is being determined. However, where a term has a different meaning under the laws of Israel and the United States or where the meaning under the laws of one of the Contracting States is not readily determinable, the competent authorities may for purposes of the Convention establish a common meaning, which may differ from the meaning under the laws of either or both Contracting States, in order to prevent double taxation or to further any other purpose of the Convention.

Article 3. FISCAL RESIDENCE

This Article sets forth rules for determining the residence of individuals, corporations, and other persons for purposes of the Convention. Residence is important because, in general, only a resident of one of the Contracting States may qualify for the benefits of the Convention. A person who, under the respective taxation laws of the Contracting States, is a resident of one Contracting State and not the other need look no further to determine his residence under the Convention. However, where a person is a resident of each of the Contracting States under its laws, paragraphs (2) and (3) of the Article must be used to determine that person's residence for purposes of the Convention. The Convention definition is, of course, exclusively for purposes of the Convention.

Under paragraph (1), the term "resident of Israel" means an Israeli corporation (as defined in Article 2 (General Definitions)) or any other person (except a corporation or any entity treated under Israeli law as a corporation) resident in Israel for purposes of Israeli tax. Similarly, "resident of the United States" means a United States corporation (as defined in Article 2 (General Definitions)) and any other person (except a corporation or any entity treated as a corporation for United States tax purposes) resident in the United States for purposes of United States tax. Thus, a resident of the United States includes a resident alien individual, an alien present in the United States who elects to be treated as a resident under Code section 6013(g) or (h), and a resident citizen, but under no circumstances, a foreign corporation. A citizen of the United States or Israel is not automatically a resident of the United States or Israel for purposes of this Convention. Whether a citizen of the United States is a resident of the United States for this purpose is to be determined by the principles of the Treasury regulations issued under Code section 871.

The Convention provides that a partnership, estate, or trust is a resident of a Contracting State only to the extent that the income derived by such person is subject to tax in such Contracting State as the income of a resident. For example, under United States law, a partnership is never, and an estate or trust is often not, taxed as such. Under the Convention, in the case of the United States, income received by a partnership, estate, or trust will not qualify for the benefits of the

Convention unless such income is subject to tax in the United States as the income of a resident. Thus, in effect, the treatment of income received by a partnership will be determined by the residence and taxation of its partners with respect to that income. To the extent the partners are subject to United States tax as residents of the United States, the partnership will be treated as a resident of the United States. Similarly, the treatment of income received by a trust or estate will be determined by the residence and taxation of the person subject to tax on such income, which may be the grantor, the beneficiaries or the trust or estate itself, as the case may be.

Under paragraph (2), an individual who is a resident of both Contracting States under paragraph (1) will be deemed to be a resident of the Contracting State in which he has his permanent home, his center of vital interests (closest personal and economic relations), a habitual abode, or his citizenship, in the order listed. In the case of an individual who is an "oleh" under section 9(16) of the Israeli Income Tax Ordinance, his center of vital interests will be deemed to be in Israel. If the issue is not settled by these tests, the competent authorities will decide by mutual agreement the one Contracting State of which he will be considered to be a resident.

Paragraph (3) provides that a corporation which qualifies both as a resident of the United States and as a resident of Israel under Article 2 (General Definitions) will be considered to be outside the scope of the Convention, except for purposes of paragraph (1) of Article 4 (Source of Income), Article 27 (Nondiscrimination), Article 29 (Exchange of Information), and Article 31 (Entry into Force). The rule is necessary because a corporation incorporated in the United States may be deemed under the Convention to be a resident of Israel if it is taxed by Israel as a body of persons resident in Israel because it is managed and controlled in Israel. As a resident of Israel, the United States would be obliged, absent this provision, to extend to that United States corporation the benefits provided by the Convention. Since it is contrary to United States tax policy to restrict United States taxation of United States corporations by tax conventions, this paragraph removes such corporations from the scope of the substantive taxing provisions of the Convention.

The exceptions to the exclusion of dual resident corporations are necessary to make the convention operate as intended. Dual resident corporations are given the benefits of the nondiscrimination provisions, and the competent authorities are given the authority to exchange information with respect to such corporations. The exception for Article 4(1) permits the United States to tax dividends paid to an Israeli resident by a corporation which is incorporated in the United States and is managed and controlled in Israel. Without this exception, the United States could not tax such dividends because of paragraph (1) of Article 6 (General Rules of Taxation) which states that a resident of one Contracting State may be taxed by the other only on income from sources in the other. The exception for Article 31 (Entry into Force) assures that the Convention will enter into force for dual resident corporations with respect to those provisions for which they are covered. Situations of dual corporate residence should be infrequent.

Article 4. SOURCE OF INCOME

This Article contains the source rules which are to be used in applying the provisions of the Convention. Under Article 6 (General Rules of Taxation), one Contracting State may tax a resident of the other Contracting State only on income from sources within the first-mentioned Contracting State (provided, with certain exceptions, that the resident is not a citizen of the first-mentioned Contracting State).

Paragraph (1) provides that dividends will be treated as income from sources within a Contracting State only if paid by a corporation of that Contracting State.

Under paragraph (2), interest will be treated as income from sources within a Contracting State only if paid by that Contracting State, a political subdivision or a local authority thereof, or by a resident of that Contracting State. However, if interest is paid on an indebtedness incurred in connection with a permanent establishment which bears such interest, then such interest shall be deemed to be from sources within the State (whether or not a Contracting State) in which the permanent establishment is situated. This exception permits a Contracting State, under the proper circumstances, to impose a tax on interest paid by a permanent establishment therein, including a permanent establishment of a resident of a State other than a Contracting State. For example, if a resident of France has a permanent establishment in Israel which borrows money from a resident of the United States and bears the interest (i.e., deducts the interest in computing the income of the permanent establishment) the interest will be deemed to be from Israeli sources. Thus, Israel may tax such interest, subject to the limitations of Article 13 (Interest). As provided in paragraph (9) of Article 5 (Permanent Establishment) the principles of Article 5 will be applied to determine whether the resident of France has a permanent establishment in Israel. The United States will not, because of sections 861(a)(1)(C) and (D) of the Code, impose a tax on interest received by nonresident alien individuals or foreign corporations from a foreign corporation having a permanent establishment in the United States unless 50 percent or more of the gross income of such corporation from all sources for the three year period ending with the close of its taxable year preceding the payment of the interest (or such part of the period as the corporation has been in existence) was effectively connected with the conduct of a trade or business within the United States.

In addition, the exception to the general rule of paragraph (2) of this Article will exempt interest from tax in the Contracting State in which the payor resides if the payor has a permanent establishment in a State other than a Contracting State in connection with which the indebtedness on which the interest is paid was incurred, such interest is borne by the permanent establishment and such interest is paid to a resident of the other Contracting State. This results from the restriction in Article 6 (General Rules of Taxation) that a resident of one Contracting State who is not a citizen of the other Contracting State may be taxed by the other Contracting State only on income from sources within that other Contracting State.

Paragraph (3) provides that royalties for the use of, or the right of use, property or rights described in paragraph (2) of Article 14 (Royalties) will be treated as income from sources within a Contracting State only to the extent that such royalties are for the use of, or the right to use, such property or rights within that Contracting State.

Paragraph (4) provides that income and gains (including royalties) to which Article 7 (Income from Real Property) applies will be treated as income from sources within a Contracting State only if the real property (or, in the case of property referred to in paragraph (3) of Article 7, the underlying real property) is situated in that Contracting State.

Paragraph (5) provides that income from the rental of tangible personal (movable) property will be treated as income from sources within a Contracting State only to the extent that the income is for the use of such property in that Contracting State.

Under paragraph (6), income from the purchase and sale, exchange, or other disposition of intangible or tangible personal property (other than gains described in paragraph (2) of Article 14 (Royalties)) will be treated as income from sources within a Contracting State only if such sale, exchange, or other disposition is within that Contracting State. However, gains from the sale, exchange, or other disposition of stock in an Israeli corporation to which paragraph (1)(e) of Article 15 (Capital Gains) applies will be treated as income from sources within Israel.

Under paragraph (7), income received by an individual for his performance of labor or personal services, whether as an employee or in an independent capacity, will be treated as income from sources within a Contracting State only to the extent that such services are performed in that Contracting State. Income from personal services performed aboard ships or aircraft operated by a resident of a Contracting State in international traffic will be treated as income from sources within that Contracting State if rendered by a member of the regular complement of the ship or aircraft. However, remuneration described in Article 22 (Governmental Functions) and payments described in Article 21 (Social Security Payments) paid from the public funds of a Contracting State or a political subdivision or local authority thereof will be treated as income from sources within that Contracting State only.

Paragraph (8) contains a general qualification to the preceding source rules. It provides that industrial or commercial profits attributable to a permanent establishment which the recipient, a resident of one Contracting State, has in the other Contracting State will be treated as income from sources within that other Contracting State. Industrial or commercial profits attributable to such permanent establishment may include any item of income described in paragraphs (1) through (6) if the item of income is effectively connected wtih the permanent establishment. See the discussion of paragraph (6) of Article 8 (Business Profits) for a discussion of the effectively connected concept.

Under paragraph (9), the source of any item of income not described in the preceding paragraphs of Article 4 will be determined by each Contracting State in accordance with its own law. However, if the source of any item of income under the laws of one Contracting State is different from its source under the laws of the other Contracting State or if its source is not readily determinable under the laws of one of the Contracting States, the competent authorities of the Contracting State may, in order to prevent double taxation or further any other purpose of the Convention, establish a common source of the item of income for purposes of the Convention.

Several of the source rules set out in this Article differ to some degree from those provided in the Code. Since Article 6 (General Rules of Taxation) provides, in effect, that the Convention will not increase a person's overall United States tax, a taxpayer is not bound to apply the Convention rules in calculating his United States tax liability. However, a taxpayer may not make inconsistent choices between Code and Convention rules.

Article 5. PERMANENT ESTABLISHMENT

This Article defines the term "permanent establishment." The existence of a permanent establishment is relevant under Article 8 (Business Profits) to the taxation of industrial or commercial profits and in determining the applicability of other provisions of the Convention.

Under paragraph (1), the term "permanent establishment" means a fixed place of business through which a resident of one of the Contracting States engages in industrial or commercial activity. Illustrations in paragraph (2) of a fixed place of business include a branch; an office; a factory; a warehouse; a workshop; a farm or plantation; a store or other sales outlet; a mine, quarry or other place of extraction of natural resources; a building site, or construction or assembly project, or supervision activity connected therewith and conducted within the Contracting State where such site or project is located, where such site, project or activity continues for a period of more than six months; and the maintenance of substantial equipment or machinery, including for example, a drilling rig, within a Contracting State for a period of more than six months. As a general rule, any fixed facility or premises through which a resident conducts industrial or commercial activity for an indefinite or substantial period of time will be treated as a fixed place of business unless it is used only for one or more of the activities described in paragraph (3).

Under the building site or construction or installation project rule, the six months period begins only when work or supervision physically commences in the other Contracting State. A series of contracts or projects which are interdependent both commercially and geographically is to be treated as a single project for the purpose of applying the six months test.

Paragraph (3) specifically provides that a permanent establishment does not include a fixed place of business if it is used only for one or more of the following:

"(a) The use of facilities for the purpose of storage, display, or delivery of goods or merchandise belonging to the resident;

"(b) The maintenance of a stock of goods or merchandise belonging to the resident for the purpose of storage, display, or delivery (other than goods or merchandise held for sale by such resident in a store or other sales outlet);

"(c) The maintenance of a stock of goods or merchandise belonging to the resident for the purpose of processing by another person;

"(d) The maintenance of a fixed place of business for the purpose of purchasing goods or merchandise, or for collecting information for the resident;

"(e) The maintenance of a fixed place of business for the purpose of advertising, for the supply of information, for scientific research, or for similar activities which have a preparatory or auxiliary character, for the resident;

"(f) A building site, or construction or assembly project, or supervision activity connected therewith, where such site, project, or activity continues for a period of not more than 6 months, or

"(g) The maintenance of substantial equipment or machinery within a Contracting State for a period of not more than 6 months."

As noted, a fixed place of business used only for one or more of these purposes will not be considered a permanent establishment under the Convention. The exception of paragraph (3)(b) relating to the maintenance of a stock of goods or merchandise for the purpose of storage, display, or delivery contains language which makes clear that goods held for sale in a store or other sales outlet are not included in the exception. This emphasizes the rule that goods held in a store or other sales outlet are not merely being held for storage, display or delivery.

Paragraph (4) provides that even though a resident of one Contracting State does not have a permanent establishment in the other Contracting State under paragraphs (1), (2), and (3), such resident will be deemed to have a permanent establishment in the other Contracting State if such resident sells in that Contracting State goods or merchandise which either were subjected to substantial processing in that Contracting State (whether or not purchased in that Contracting State), or were purchased in that Contracting State and not subjected to substantial processing outside that Contracting State.

Under paragraph (5), a person acting in one Contracting State on behalf of a resident of the other Contracting State, other than an agent of an independent status to whom paragraph (6) applies, will be deemed to constitute a permanent establishment if such person has, and habitually exercises in that first-mentioned Contracting State, an authority to conclude contracts in the name of the resident, unless the exercise of the authority is limited to the purchase of goods or merchandise for the resident.

On the other hand, paragraph (6) provides that a resident of one Contracting State will not be deemed to have a permanent establishment in the other Contracting State merely because such resident engages in industrial or commercial activity in such other Contracting State through a broker, general commission agent, or any other agent of an independent status, where such broker or agent is acting in the ordinary course of his business.

Paragraph (7) provides that a resident of one Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because such resident sells at the termination of a trade fair or convention in the other Contracting State goods or merchandise which were displayed by such resident at the trade fair or convention. The trade fair exception is not intended to apply with respect to goods in the resident's inventory.

Under paragraph (8), the determination of whether a resident of one Contracting State has a permanent establishment in the other Contracting State is to be made without regard to the fact that such resident may be related to a resident of the other Contracting State or to a person who engages in business in that other Contracting State (whether through a permanent establishment or otherwise). What is relevant is whether the resident of the other State carries on for the resident of the first-mentioned State an activity which, within the provisions of this Article, would make the resident of the other State a dependent agent of the resident of the first-mentioned State. As defined in Article 11 (Related Persons), a person is related to another person if either person owns or controls directly or indirectly the other, or if a third person or persons own or control directly or indirectly both.

Paragraph (9) provides that the principles set forth in this Article are to be applied in determining whether there is a permanent establishment in a State other than one of the Contracting States or whether a person other than a resident of one of the Contracting States has a permanent establishment in one of the Contracting States. This is necessary for the proper application of paragraph (2) of Article 4 (Source of Income). This paragraph is not intended to extend the benefits of the Convention to persons other than residents of the two Contracting States.

Article 6. GENERAL RULES OF TAXATION

Under paragraph (1), a resident of one Contracting State may be taxed by the other Contracting State on any income from sources within that other Contracting State and only on such income, subject to the limitations set forth in the Convention. For this purpose, the source rules contained in Article 4 (Source of Income) are to be applied. However, if the resident is a citizen of the other Contracting State, that Contracting State may tax the resident without regard to this paragraph because of the saving clause of paragraph (3) of this Article.

Paragraph (2) contains the customary rule that the Convention will not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded by the laws of a Contracting State in the determination of a tax imposed by it, or by any other agreement between the Contracting States. Thus, if a deduction would be allowed under the Code for an item in computing the taxable income of an Israeli resident, such deduction is generally available to him in computing taxable income under the Convention. Paragraph (2) does not, however, authorize a taxpayer to make inconsistent choices between rules of the Code and rules of the Convention. In no event are the rules of the Convention to increase the U.S. or Israeli tax burden from what that liability would be if there were no Convention. Thus, a right to tax given by the Convention cannot be exercized unless that right also exists under the Code.

Paragraph (3) contains the traditional saving clause under which the United States reserves the right to tax its citizens and residents (determined under Article 3 (Fiscal Residence)) as if the Convention had not come into effect. However, under paragraph (4), the saving clause does not apply in several cases in which its application would contravene policies reflected in the Convention. These policies are specifically designed to extend treaty benefits to citizens or residents. Thus, the saving clause does not affect the provisions with respect to grants, charitable contributions, social security payments, relief from double taxation, nondiscrimination, or the mutual agreement procedure, which are available to residents and citizens of the Contracting States. Moreover, the saving clause does not affect the benefits of the Convention provided to individuals performing governmental functions, teachers, students and trainees, and diplomatic or consular officers who are neither citizens of, nor have immigrant status in, the Contracting State imposing the tax. In the case of the United States, "immigrant status" means the individual has been admitted to the United States for permanent residence. The saving clause is reciprocal.

Paragraph (5) reserves the right of the United States to impose its personal holding company tax under section 541 of the Code and its accumulated earnings tax under section 531 of the Code notwithstanding any provision of the Convention. However, paragraph (5) also provides that an Israeli corporation will be exempt from the personal holding company tax in any taxable year unless United States residents or citizens own, directly or indirectly, within the meaning of section 544 of the Code, ten percent or more in value of the outstanding stock of the corporation at any time during the taxable year. In addition, an Israeli corporation will be exempt from the accumulated earnings tax in any taxable year unless at least twenty-five percent of the voting stock of such corporation is owned by United States citizens or residents.

Paragraph (6) provides a special rule for cases where income dealt with by this Convention is taxable to a resident of a Contracting State only if, and to the extent, it is remitted to or received by that person. In certain cases, individuals who are residents of Israel are not taxable on foreign source investment income, unless it is remitted to or received by them in Israel. If such income is received outside of Israel or accumulated by the payer, an Israeli resident may not be subject to tax on that income. If the reductions in rates or exemptions from tax were to apply to those items of income, the United States would be foregoing tax where double taxation does not in fact occur. Thus, this paragraph provides that if under the law in the other Contracting State income would only be taxed on a remittance basis, then any reduced rates of tax provided by this Convention shall apply only to the extent such income is remitted to or received by the person in that other Contracting State in the year in which it accrues to the benefit of that taxpayer. This rule applies to all persons, including individuals, corporations, partnerships and trusts or estates taxable as such.

Paragraph (7) authorizes the competent authorities of the Contracting States to prescribe regulations necessary to carry out the provisions of the Convention. For the United States, this authority is also provided by section 7805 of the Code.

Article 7. INCOME FROM REAL PROPERTY

Under paragraph (1), income from real property, including royalties and other payments in respect of the exploitation of natural resources (e.g., oil wells) and gains from the sale, exchange or other disposition of such property or of the right giving rise to such royalties or other payments, may be taxed by the Contracting State in which the real property or natural resources are situated. Thus, natural resource royalties are covered under this Article and not under Article 14 (Royalties).

However, income from real property does not include interest on indebtedness secured by real property (e.g., mortgages) or secured by a right giving rise to royalties or other payments in respect of the exploitation of natural resources. Such interest income is covered by Article 13 (Interest). The rule of this paragraph, however, does not confer an exclusive right of taxation on the State where the property is located.

Under paragraph (2), paragraph (1) applies to income derived from the usufruct, direct use, letting, or use in any other form of real property.

Paragraph (3) provides, consistent with U.S. law, that gains from the alienation of shares of a company the property of which consists, directly or indirectly, principally of real property situated in a Contracting State may be taxed by that State. Paragraph (4) of Article 4 (Source of Income) provides that these gains will be considered from sources within a Contracting State if the real property owned by the company is situated in that State.

This Article does not contain a provision allowing for the taxation of real property income on a net basis. This is because such treatment is already provided for under the laws of both Contracting States.

Article 8. BUSINESS PROFITS

Paragraph (1) sets forth the general rule that industrial or commercial profits of a resident of one Contracting State are exempt from tax by the other Contracting State unless the resident has a permanent establishment in the other Contracting State. Where there is a permanent establishment, only the industrial or commercial profits attributable to the permanent establishment can be taxed by that other Contracting State, unless the resident is a citizen of that other Contracting State. (See the saving clause in paragrpah (3) of Article 6 (General Rules of Taxation)). Under paragraph (8) of Article 4 (Source of Income), industrial or commercial profits, whether otherwise treated as from sources within or without a Contracting State, which are attributable to a permanent establishment which a resident of one Contracting State has in the other Contracting State will be considered to be from sources within that other Contracting State. Thus, items of income described in section 864(c)(4)(B) of the Code attributable to a permanent establishment situated in the United States will be subject to tax by the United States. The limited "force of attraction" rule under Code section 864(c)(3) does not apply for U.S. tax purposes under the Convention.

In determining the proper attribution of industrial or commercial profits under the Convention, paragraph (2) provides that both Contracting States will attribute to the permanent establishment such profits as it would reasonably be expected to derive if it were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the resident of which it is a permanent establishment. Under paragraph (3), expenses, wherever incurred, which are reasonably connected with profits attributable to the permanent establishment, including executive and general administrative expenses, will be allowed as deductions in determining the industrial or commercial profits of the permanent establishment. However, in determining the amount of the deduction under paragraph (3) for expenses incurred by the head office, the deductions may be limited to the expense incurred without including a profit element for the head office.

Paragraph (4) provides that no profits shall be attributed to a permanent establishment merely because of the purchase of goods or merchandise by that permanent establishment, or by the resident of which it is a permanent establishment, for the account of such resident. Paragraph (2) of the Article does not override paragraph (4). Thus, where a permanent establishment purchases goods for its head office, the industrial and commercial profits attributed under paragraph (2) to the permanent establishment with respect to its other activities will not be increased by adding a notional figure for profits from purchasing.

Under paragraph (5), the term "industrial or commercial profits" includes income derived from manufacturing, mercantile, banking, insurance, agricultural, fishing or mining activities, the operation of ships or aircraft, the furnishing of services, and the rental of tangible personal (movable) property. The term does not include income from the rental or licensing of motion picture films or films or tapes used for radio or television broadcasting, or income from the performance of personal services derived by an individual either as an employee or in an independent capacity.

Under paragraph (6), the term "industrial and commercial profits" also includes income from dividends, interest, royalties described in paragraph (2) of Article 14 (Royalties), and capital gains and income derived from property and natural resources, but only if the income is effectively connected with a permanent establishment. See paragraph (4) of Article 12 (Dividends), paragraph (5) of Article 13 (Interest), paragraph (3) of Article 14 (Royalties) and paragraph (1)(c) of Article 15 (Capital Gains).

Paragraph (6) also contains criteria for determining whether income is effectively connected with a permanent establishment. Factors to be taken into account include whether the rights or property giving rise to such income are used in, or held for use in, carrying on an activity giving rise to industrial or commercial profits through a permanent establishment and whether the activities carried on through such permanent establishment were a material factor in the realization of the income. For this purpose, due regard will be given to whether or not such property or rights or such income were accounted for through such permanent establishment. The rules of this paragraph are similar to those found in section 864 of the Code.

Under paragraph (7), where industrial or commercial profits include items of income which are dealt with separately in other articles of the Convention, the provisions of those articles will, except as otherwise provided therein, supersede the provisions of this Article. Thus, for example, taxation of interest income will be controlled by Article 13 (Interest) and not by this Article unless the interest is attributable to a permanent establishment.

Paragraph (8) provides that the United States excise tax on insurance premiums paid to foreign insurers, imposed by section 4371 of the Internal Revenue Code, which is a covered tax under paragraph (1)(a) of Article 1 (Taxes Covered), will not apply to insurance or reinsurance premiums received by a business of insurance conducted by a resident of Israel regardless of whether that business is carried on through a permanent establishment in the United States. This provision applies only to the extent that the relevant risk is not reinsured, directly or indirectly, with a person not entitled to relief from such tax.

Under paragraph (1) of Article 8 (Business Profits) and subparagraph (1)(a) of Article 1 (Taxes Covered) of the Convention, no insurance excise tax (or income tax) is payable with respect to premiums paid to a resident of Israel if the resident does not have a permanent establishment in the United States. In the case of an resident of Israel with a permanent establishment in the United States, the United States will not impose the insurance excise tax. (See Revenue Ruling 80-225.)

Article 9. SHIPPING AND AIR TRANSPORT

Paragraph (1) provides that, notwithstanding Article 8 (Business Profits) and Article 15 (Capital Gains), income derived by a resident of one Contracting State from the operation in international traffic of ships or aircraft, and gains derived from the sale, exchange or other disposition of such ships or aircraft, shall be exempt from tax by the other Contracting State. It should be noted that income derived by a resident of Israel would be exempt from tax by the United States even though the vessel with respect to which the income is earned is registered in a State which would not qualify for the reciprocal exemption of Code sections 872(b) and 883(a).

Under paragraph (2), this Article applies to income derived from the rental of such ships or aircraft under a full or bareboat charter if the lessor is engaged in the operation of ships or aircraft in international traffic and the rental income is incidental to such operations of the lessor. For example, if an airline which is a resident of one Contracting State has excess equipment in the winter months and leases several of its aircraft which are not required by it during that period to an airline which is a resident of the other Contracting State, that rental income of the lessor is not subject to tax by that other Contracting State.

Paragraph (2) also makes clear that the Article applies to income derived by a resident of one Contracting State from the use, maintenance, and lease of containers, trailers for the inland transportation of containers and other related equipment in connection with the operation by a resident in international traffic of ships or aircraft described in paragraph (1).

This Article is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Therefore, a Contracting State may tax income from international traffic derived by a resident of the other Contracting State without regard to this Article if such resident is a citizen of the first-mentioned Contracting State.

Article 10. GRANTS

This Article details the manner in which Israeli governmental grants to United States residents will be treated for United States tax purposes.

Paragraph (1) provides that for the purpose of computing United States tax, if Israel, a political subdivision thereof, or any agency of either makes a qualifying cash grant to a United States resident, then the amount of such grant will be included in the gross income of such resident unless the U.S. resident elects to exclude it. If he does not so elect, and the grant is included in income, the U.S. resident would increase his basis in the stock of the Israeli corporation by the amount of the grant. If he so elects, and if the resident is a corporation, the amount of such grant will be treated as a contribution to its capital.

The electing United States resident will be considered to have contributed the amount of such grant to the Israeli corporation designated by the terms of the grant, and the resident's basis for the stock of the Israeli corporation will not be increased by the amount of the contributed grant. The basis of the assets of the Israeli corporation (for purposes of determining the Israeli subsidiary's earnings and profits for U.S. tax purposes) will be reduced by the amount of the deemed contribution, in accordance with rules prescribed by the Secretary of the Treasury. The Convention has no special provision with respect to a U.S. resident who acquires assets directly from the proceeds of a grant. Thus, for example, if the U.S. resident is a corporation, the rules of section 362(c) of the Code will apply and the U.S. resident will be required to reduce its basis in certain assets acquired after the contribution.

Pargraph (2) defines a qualifying cash grant as one approved by Israel for investment promotion in Israel. A qualifying grant will not include any amount which in whole or part, directly or indirectly, (a) is in consideration for services rendered or to be rendered by either the United States resident or the Israeli subsidiary, or for the sale of goods; (b) is measured in any manner by the amount of profits or tax liability of the investor or the Israeli corporation in which the investment is made; or (c) which is taxed by Israel. A grant will qualify where it is made by Israel, or a political subdivision thereof, on the basis of the enterprise meeting an approved project's social or economic objectives, which may include, for example, creating employment, generating or conserving foreign exchange, tourism, or developing less developed regions. It is contemplated that qualifying grants may be made before commencement of an investment or after the investment has been made and may be based upon whether or not the enterprise has fulfilled the conditions of investment.

Article 11. RELATED PERSONS

This Article complements section 482 of the Code and confirms the authority of the United States under that section. Where a person subject to the taxing jurisdiction of a Contracting State (whether or not a resident therof) and any other related person make arrangements or impose conditions between themselves which are different from those which would be made between independent persons, under paragraph (1), any income, deductions, credits or allowances which would, but for those arrangements or conditions, have been taken into account in computing the income or loss of, or the tax payable by, one of such persons, may be taken into account in computing the amount of the income subject to tax and the taxes payable by such person in that Contracting State.

Paragraph (2) sets forth an explicit formulation of the consequence of a redetermination made in accordance with paragraph (1) by a Contracting State to the income of one of its residents. In such event, the other Contracting State will, if it agrees with such redetermination and if necessary to prevent double taxation, make a corresponding adjustment to the income of a person in such other Contracting State related to such resident. If the other Contracting State disagrees with the redetermination, the two Contracting States will endeavor to reach agreement in accordance with the mutual agreement procedure in paragraph (2) of Article 28 (Mutual Agreement Procedure).

Paragraph (3) provides that for purposes of the Convention a person is related to another person if either person owns or controls directly or indirectly the other, or if a third person or persons own or control directly or indirectly both. "Control" includes any kind of control, whether or not legally enforceable, and however exercised or exercisable.

Article 12. DIVIDENDS

Paragraph (1) provides that dividends derived from sources within one Contracting State by a resident of the other Contracting State may be taxed by both Contracting States.

Paragraph (2) limits the rate of tax in the Contracting State of source, in general, to a rate not in excess of twenty-five percent of the gross amount of the dividend paid. However, if the dividend recipient is a corporation, two special rules are provided. Under subparagraph (2)(b), where the dividend is paid out of income for a period during which the paying corporation is not entitled to the reduced rate of tax applicable to an approved enterprise under Israel's Encouragement of Capital Investments Law (1959), the rate of tax in the Contracting State of source may not exceed twelve and one-half percent of the gross amount of the dividend paid. Under subparagraph (2)(c), a maximum rate of 15 percent of the gross dividend is provided for dividends paid for a period during which the paying corporation is entitled to the reduced rates applicable to a an approved enterprise under Israel's Encouragement of Capital Investments Law (1959). These special rate limitations only apply if during the part of the paying corporation's taxable year which precedes the date of payment of the dividend and during the whole of its prior taxable year (if any), at least ten percent of the outstanding voting stock of the corporation was owned by the recipient corporation, and not more than twenty-five percent of the gross income of the paying corporation for such prior taxable year (if any) consists of interest or dividends (other than interest derived from the conduct of a banking, insurance, or financing business and dividends or interest received from subsidiary corporations, fifty percent or more of the outstanding voting stock of which is owned by the paying corporation at the time such dividends or interest is received). These rate limitations do not affect the taxation of profits of the company which pays the dividends.

Paragraph (3) provides that dividends paid by a corporation of one Contracting State to a person other than a resident of the other Contracting State (and in the case of dividends paid by an Israeli corporation, to a person other than a citizen of the United States) will be exempt from tax by the other Contracting State.

Paragraph (4) provides that the limitations of paragraphs (2) and (3) will not apply if the dividends are treated, under paragraph (6) of Article 8 (Business Profits), as industrial or commercial profits attributable to a permanent establishment which the recipient has in the other Contracting State. In such case, the provisions of Article 8 (Business Profits) will apply. If the recipient of the dividend is a citizen of the source Contracting State, that Contracting State may tax the recipient without regard to this Article because of the saving clause of paragraph (3) of Article 6 (General Rules of Taxation).

No definition of the term "dividends" is provided. Accordingly, each Contracting State may use the definition under its domestic law, unless the context otherwise requires or the competent authorities agree to a common meaning. See paragraph (2) of Article 2 (General Definitions).

Article 13. INTEREST

Paragraph (1) provides that interest derived by a resident of one Contracting State from sources within the other Contracting State may be taxed by both Contracting States. However, paragraph (2) limits the rate of tax in the Contracting State of source to a rate not in excess of 17.5 percent of the gross amount of the interest. If the interest is derived from a loan of whatever kind granted by a bank, savings institution, insurance company, or the like, the rate of tax in the Contracting State of source may not exceed ten percent of the gross amount of the interest.

Paragraph (3) provides that interest beneficially derived by one of the Contracting States, or by an instrumentality of that Contracting State not subject to tax by that Contracting State on its income, will be exempt from tax by the other Contracting State. Under this rule, interest income derived by the Export-Import Bank of the United States and the Overseas Private

Investment Corporation (OPIC) on loans made to Israeli residents will be exempt from tax in Israel. Similarly, income derived by the Bank of Israel on loans made to residents of the United States will be exempt from U.S. tax. The exemption also applies where a resident of a Contracting State receives interest income with respect to debt obligations guaranteed or insured by that Contracting State or an instrumentality thereof.

Paragraph (4) provides that interest paid by a resident of one Contracting State to a person other than a resident of the other Contracting State (and in the case of interest paid by a resident of Israel, to a person other than a United States citizen) will be exempt from tax by the other Contracting State unless such interest is treated as income from sources within the other Contracting State under paragraph (2) of Article 4 (Source of Income).

Paragraph (5) provides that the limitations of paragraphs (2), (3), and (4) will not apply if the interest is treated, under paragraph (6) of Article 8 (Business Profits), as industrial or commercial profits attributable to a permanent establishment which the recipient has in the other Contracting State. In such a case, the provisions of Article 8 (Business Profits) will apply.

If excessive interest is paid to a related person, paragraph (6) provides that the Article does not apply to the excessive portion of the payment. The excessive portion may be taxed by each Contracting State according to its own laws, including the Convention where applicable. In the case of the United States, the excessive portion may be taxed as a dividend, in which case the provisions of Article 12 (Dividends) will apply.

Paragraph (7) defines "interest" for purposes of the Convention as income from money lent and other income which under the taxation law of the Contracting State in which the income has its source is assimilated to income from money lent.

This Article is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Therefore, interest derived by a citizen of the source Contracting State may be taxed by that Contracting State without regard to this Article.

Article 14. ROYALTIES

Paragraph (1) provides that royalties derived by a resident of one Contracting State from sources within the other Contracting State may be taxed by both Contracting States. However, paragraph (1) limits the tax in that other Contracting

State to a rate not to exceed ten percent of the gross amount of a copyright or film royalty or fifteen percent of the gross amount of an industrial royalty.

The term "copyright or film royalties" is defined in paragraph (2)(a) as payments of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, or scientific works, including copyrights of motion picture films or films or tapes used for radio or television broadcasting. The term "industrial royalties" is defined in paragraph (2)(b) as payments of any kind made as consideration for the use of, or the right to use, patents, designs, models, plans, secret processes or formulae, trademarks, or other like property or rights. Copyright or film royalties and industrial royalties include gains derived from the sale, exchange, or other disposition of such property or rights to the extent the amounts realized on such sale, exchange or other disposition for consideration are contingent on the productivity, use, or disposition of the property or rights. If the amounts realized are not so contingent, the provisions of Article 15 (Capital Gains) may apply. The term "royalties" does not include royalties and other payments in respect of the exploitation of natural resources. Such payments are covered by the provisions of Article 7 (Income from Real Property). See also paragraph (6) of Article 8 (Business Profits).

Paragraph (3) provides that the tax rate limitations of paragraph (1) shall not apply if the royalty is treated, under paragraph (6) of Article 8 (Business Profits), as industrial or commercial profits attributable to a permanent establishment which the recipient has in the other Contracting State. In such a case, the provisions of Article 8 (Business Profits) will apply.

If excessive royalties are paid to a related person, paragraph (4) provides that the Article does not apply to the excessive portion of the royalty. The excessive portion may be taxed by each Contracting State according to its own laws, including the Convention where applicable. Thus, the excessive portion may be treated as a dividend or interest, or in whatever other manner is appropriate. But if, for example, it is treated as a dividend, the rules of Article 12 (Dividends) will be applied.

As noted under paragraph (3) of Article 4 (Source of Income), royalties (including contingent gains) will be treated as income from sources within a Contracting State only to the extent they are payments made as consideration for the use of, or the right to use, property or rights described in paragraph (2) within that Contracting State. This source rule is similar to the source rule in section 861(a)(4) of the Code.

This Article is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Therefore, royalties derived by a citizen of the source Contracting State may be taxed by that Contracting State without regard to this Article.

Article 15. CAPITAL GAINS

Under paragraph (1), a resident of one Contracting State will be exempt from tax by the other Contracting State on gains from the sale, exchange or other disposition of capital assets. However, the exemption does not apply if (a) the gain is from the sale, exchange or other disposition of property described in Article 7 (Income from Real Property) situated within the other Contracting State; (b) the gain is from the sale, exchange or other disposition of property described in paragraph (2)(c) of Article 14 (Royalties); (c) the gain is treated, under paragraph (6) of Article 8 (Business Profits), as industrial or commercial profits attributable to permanent establishment which the resident has in the other Contracting State; or (d) the resident is an individual who is present in the other Contracting State for a period or periods aggregating 183 days or more during the taxable year. For purposes of this Article and the other physical presence tests contained in the Convention with regard to an individual, the term "day" means a calendar day during any portion of which the individual is physically present in the relevant Contracting State.

Paragraph (1) contains an additional exception to the capital gains exemption which is not in previous United States conventions. Under Israeli tax law, gains from the sale of stock in an Israeli corporation are subject to tax by Israel regardless of the residence of the alienator or place where the sale occurs. The additional exception in paragraph (1) is intended to limit this rule of Israeli taxation. This exception will apply (i.e., Israel will preserve its right to tax) only if the gain is derived from the sale, exchange or other disposition of stock in an Israeli corporation by a resident of the United States who owns either actually or constructively within the twelve month period preceding the sale, exchange, or other disposition, stock possessing more than fifty percent of the voting power of the Israeli corporation, and more than fifty percent of the fair market value of the Israeli corporation's gross assets used in its trade or business are physically located in Israel on the last day of each of the three taxable years preceding the sale, exchange, or other disposition (or, if the corporation has been in existence for less than three years, on the last day of each preceding taxable year of the corporation).

Paragraph (2) provides that the provisions of Article 7 (Income from Real Property) will apply to real property gains; the provisions of Article 14 (Royalties) will apply to certain royalty gains; and the provisions of Article 8 (Business Profits) will apply to gains attributable to a permanent establishment.

If the recipient of the gain is a resident of one Contracting State and a citizen of the other Contracting State, that other Contracting State may tax the recipient without regard to this Article because of the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Where Article 9 (Shipping and Air Transport) applies to gains derived from the sale, exchange or other disposition of property, this Article does not apply to such gains.

Article 15-A. CHARITABLE CONTRIBUTIONS

Article 15-A provides rules under which a resident of one Contracting State (and, in the case of the United States, a U.S. citizen) may make a gift to a charitable organization in the other State, which will be treated for tax purposes, by the State of residence (or citizenship in the case of the United States) as a charitable contribution.

Paragraph (1) deals with the U.S. tax treatment of gifts by U.S. citizens or residents to Israeli charities. It provides that if a U.S. citizen or resident makes a contribution to an organization created or organized under the laws of Israel, that contribution will be treated as a charitable contribution for U.S. tax purposes, for the taxable year in which the gift is made, if and to the extent that the contribution would have been so treated if the organization had been created or organized under the laws of the United States. This rule applies, however, only to contributions which do not exceed 25 percent of the contributor's taxable income (if a corporation) or adjusted gross income (if an individual) for the year from Israeli sources.

Paragraph 2 applies, *mutatis mutandis*, to a gift by an Israeli resident to an American organization.

The Article determines whether any particular gift is to be treated as a charitable contribution. Whether, or the extent to which a deduction (or, in the case of Israel, a credit) is to be allowed by the country of residence for the contribution continues to be governed by the limitations in the taxation laws of that Contracting State. For example, assume a U.S. resident with $50,000 of adjusted gross income, $10,000 of which is from Israeli sources. His contributions to U.S. charitable organizations total $25,000, and he contributes $5,000 to qualifying Israeli organizations. Assume, further, that all the contributions qualify under Code section 170(b)(1)(A) and are, therefore, deductible up to 50 percent of adjusted gross income. His charitable contributions, under paragraph (1) of the Article, would be $27,500--the full $25,000 of contributions to U.S. organizations and $2,500 (25 percent of $10,000) of contributions to Israeli charities. His limit for current year deductions under U.S. law is $25,000. Thus, he may deduct $25,000 in the current year and carry over $2,500 for future years. Once a contribution to an Israeli charitable organization qualifies as a charitable contribution it becomes indistinguishable from other charitable contributions. There is no need, therefore, in the example above, to determine whether the carryover of excess contributions reflects contributions to Israeli or American charities. Thus, even if the contributor has no Israeli source income in future years, his right to use the carryover is not affected.

In notes exchanged at the time of the signing of the treaty, it was agreed that an effort would be made to develop procedures to simplify the determination by one Contracting State that an organization in the other Contracting State is eligible to receive charitable contributions from residents of the first-mentioned State. The competent authorities of each Contracting State will review the procedures and requirements of the other Contracting State for certifying an organization of that other State as eligible to receive charitable contributions. If the competent authorities find that the procedures do not differ substantially as between the two Contracting States, it is contemplated that the authorities of each State will accept certification by the other and will not require recipient organizations to qualify separately in both States.

Article 16. INDEPENDENT PERSONAL SERVICES

In dealing with the taxation of income from personal services the Convention distinguishes between "independent" and "dependent" personal services. The Convention also provides special treatment for individuals who are "public entertainers" and for amounts received for furnishing the personal services of others.

Services performed by an individual in an independent capacity are services performed for his own account where he receives the income and bears the losses arising from such services. If an individual is an independent contractor he is considered as rendering independent personal services. Generally, services rendered by physicians, lawyers, engineers, architects, dentists and accountants performing personal services as sole proprietors or partners are independent personal services.

Under paragraph (1), income derived by an individual resident of one Contracting State from the performance of personal services in an independent capacity may be taxed only by that Contracting State. However, under paragraph (2), such income derived from services performed in the other Contracting State may also be subject to tax in that other Contracting State if the individual is present therein for a period or periods aggregating 183 days or more in the taxable year. Under the saving clause of paragraph (3) of Article 6 (General Rules of Taxation), the other Contracting State may also tax any individual who is a citizen of that other Contracting State without regard to this Article.

Article 17. DEPENDENT PERSONAL SERVICES

Under paragraph (1), wages, salaries, and similar remuneration derived by an individual who is a resident of one Contracting State from labor or personal services performed as an employee, including income from services performed by an officer of a corporation or company, may be taxed by that Contracting State. If such remuneration is derived from sources within the other Contracting State, it may be taxed by that other Contracting State unless it is exempt from tax in that other State under paragraph (2) or under Articles 20 (Private Pensions and Annuities), 22 (Governmental Functions), 23 (Teachers) and 24 (Students and Trainees).

Under paragraph (2), dependent personal service income derived by an individual resident of one Contracting State will be exempt from tax by the other Contracting State if: (a) the individual is present in that other Contracting State for a period or periods aggregating less than 183 days in the taxable year; (b) the individual is an employee of a resident of the first-mentioned Contracting State or of a permanent establishment maintained in the first-mentioned Contracting State; (c) the remuneration is not borne as such (i.e., as a deduction for salary payments) by a permanent establishment which the employer has in the other Contracting State; and (d) the remuneration is subject to tax in the first-mentioned Contracting State. Income of a United States citizen or resident which is excluded from tax by reason of section 911 is not considered subject to tax by the United States. Such income may also be taxed by that other Contracting State without regard to this Article if the individual is a citizen of that other Contracting State, because of the saving clause of paragraph (3) of Article 6 (General Rules of Taxation).

Under paragraph (3), and notwithstanding paragraphs (1) and (2), remuneration derived by an employee (even if a resident of a State other than a Contracting State) of a resident of one Contracting State for labor or personal services performed as a member of the regular complement of a ship or aircraft operated in international traffic by a resident of that Contracting State may be taxed by that Contracting State. In addition, this paragraph is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation) so that the other Contracting State may tax its citizens or residents without regard to this paragraph.

Article 18. PUBLIC ENTERTAINERS

This Article provides that, notwithstanding Articles 16 (Independent Personal Services) and 17 (Dependent Personal Services), income derived by an individual resident in one Contracting State from his performance of personal services in the other Contracting State as a public entertainer, such as a theater, motion picture, radio or television artist, a musician, or an athlete may be taxed by the other Contracting State only if the gross amount of such income exceeds $400 or its equivalent in Israeli pounds for each day the individual is present in the other Contracting State for the purpose of performing such services therein. If the entertainer°s gross income exceeds $400 per day, he may be taxed on the full amount of his income, not just the amount in excess of $400.

If the individual receives a fixed amount for performing the services on more than one day, the amount received will be pro-rated over the number of days the individual performs the services. Thus, for example, if an entertainer resident in Israel receives $5,000 to perform in a series of 5 concerts in the United States on 5 different days and spends an additional 5 days in the United States in rehearsal for those concerts over a two week period, he will be considered to have received $500 for each day and thus, purusant to this Article, he may be taxed by the United States.

Income derived from services rendered by producers, directors, technicians, and others who are not public entertainers is taxable in accordance with the provisions of Article 16 (Independent Personal Services), or Article 17 (Dependent Personal Services), as the case may be.

Under the saving clause of paragraph (3) of Article 6 (General Rules of Taxation), if the individual is a citizen of a Contracting State, that State may tax his income without regard to this Article.

Article 19. AMOUNTS RECEIVED FOR FURNISHING PERSONAL SERVICES OF OTHERS

Paragraph (1) provides that amounts received by a resident of one Contracting State in consideration of furnishing in the other Contracting State the personal services of one or more other persons, including a public entertainer referred to in Article 18 (Public Entertainers), will not constitute industrial or commercial profits under Article 8 (Business Profits) to the extent that the person for whom the services were furnished designated the person or persons who would render the services, whether or not he had the legal right to do so and whether or not the designation was made formally; the person for whom the services were furnished had the right to designate the person or persons who would render the services; or by reason of the facts and circumstances the arrangement for personal services had the effect of designating the person or persons who would render the services; and the resident of the first-mentioned Contracting State directly or indirectly pays compensation for such services to any person, other than another resident of the first-mentioned Contracting State or of that other Contracting State who is subject to tax on such compensation. If this paragraph applies, the amounts received for providing personal services of other individuals in the other Contracting State may be taxed by that other Contracting State even though not attributable to a permanent establishment. For purposes of this paragraph, income of a United States citizen or resident which is excluded from tax by reason of section 911 is not considered subject to tax by the United States.

Paragragh (2) provides that paragraph (1) will not apply if it is established to the satisfaction of the competent authority of that other Contracting State with respect to any amount received that neither the creation nor organization of the resident of the first-mentioned Contracting State (where such resident is a corporation or other entity) nor the furnishing of the services through such resident has the effect of a substantial reduction in income, war profits, excess profits, or similar taxes. The taxes referred to in the preceeding sentence are those imposed by the two Contracting States.

Article 20. PRIVATE PENSIONS AND ANNUITIES

Except as provided in Article 22 (Governmental Functions), pensions and other similar remuneration paid to an individual will be taxable under paragraph (1) only in the Contracting State of which he is a resident. Thus, private pensions and similar remuneration derived from sources within one Contracting State by an individual resident of the other Contracting State are exempt from tax in the first-mentioned Contracting State. Pensions for Government service are dealt with in Article 22 (Governmental Functions). The term "pensions and similar remuneration" is defined in paragraph (4) as periodic payments, other than social security payments covered in Article 21 (Social Security Payments), made by reason of retirement or death and in consideration for services rendered, by way of compensation for injuries or sickness received in connection with past employment, or by reason of payments made under a plan benefitting self-employed individuals all or some of the contributions to which qualify for special tax treatment.

Paragraph (2) provides that alimony and annuities paid to an individual resident of a Contracting State will be taxable only in that Contracting State. The term "annuities" is defined in paragraph (5) as a stated sum paid periodically at stated times during life, or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than for services rendered). The term "alimony" is defined in paragraph (6) as periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support which are taxable to the recipient under the internal laws of the Contracting State of which he is a resident. Thus, the term "alimony" would not include a payment which would not be taxable to the recipient under the laws of the Contracting State in which he is a resident even though such payment is made pursuant to a decree of divorce or of separate maintenance. The explicit reference to a decree of compulsory support is consistent with section 71 of the Code.

Paragraph (3) provides that child support payments made by an individual resident of one Contracting State to an individual resident of the other Contracting State will be exempt from tax in that other Contracting State. The term "child support payments" is defined in paragraph (7) as periodic payments for the support of a minor child made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support.

This Article is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Therefore, individuals who are citizens or residents of a Contracting State may be taxed by that Contracting State without regard to this Article.

Article 21. SOCIAL SECURITY PAYMENTS

This Article provides that social security payments and other public pensions, e.g., railroad retirement benefits, paid by one

Contracting State to an individual who is a resident of the other Contracting State will be exempt from tax in both Contracting States. Payments described in Article 22 (Governmental Functions) are not covered by this Article.

Under paragraph (2) of Article 32 (Termination), this Article may be terminated by either Contracting State at any time after the Convention enters into force.

Under paragraph (4)(a) of Article 6 (General Rules of Taxation), the saving clause of paragraph (3) of Article 6 does not apply to the provisions of this Article. Thus, the exemption applies even to a citizen or resident of a Contracting State.

Article 22. GOVERNMENTAL FUNCTIONS

Under this Article, wages, salaries, and similar remuneration, including pensions, annuities, or similar benefits, paid from public funds of one Contracting State to a citizen of that Contracting State, or to a citizen of a State other than a Contracting State who comes to the other Contracting State expressly for the purpose of being employed by the first-mentioned Contracting State, for labor or personal servies performed as an employee of the national Government of that Contracting State, or any agency thereof, in the discharge of functions of a governmental nature will be exempt from tax by the other Contracting State. If the citizen becomes a citizen of, or acquires immigrant status in, the other Contracting State, that other Contracting State may tax the individual without regard to this Article. See paragraphs (3) and (4)(b) of Article 6 (General Rules of Taxation).

Whether services will be treated as performed in the discharge of governmental functions may be determined by reference to the concept of a governmental function in the State in which the income arises. Thus, compensation paid in connection with industrial or commercial activity is treated the same as compensation received from a private employer. This Article applies only to remuneration paid by the national government or agencies of the national government of a Contracting State.

Article 23. TEACHERS

Paragraph (1) provides that, if a resident of one Contracting State is invited by the other Contracting State, a political subdivision or local authority thereof, or by a university or other recognized educational institution in that other

Contracting State to come to that Contracting State for a period not expected to exceed two years for the purpose of teaching or engaging in research, or both, at a university or other recognized educational institution, and if such resident comes to that other Contracting State primarily for such purpose, his income from personal services for teaching or research at the university or educational institution will be exempt from tax by that other Contracting State for a period not exceeding two years from the date of his arrival in that other Contracting State.

Since a temporary visit may be of such a duration that an individual may lose his status as a resident of the Contracting State of which he was a resident at the time he became eligible for the benefits of this Article, the individual need only be a resident of such Contracting State at the beginning of his visit. However, if the individual becomes a citizen of, or acquires immigrant status in, the other Contracting State, that other Contracting State may tax the individual without regard to this Article. See paragraphs (3) and (4)(b) of Article 6 (General Rules of Taxation). If the individual's visit exceeds a period of two years from the date of his arrival, the exemption applies only to the income received by the individual before the expiration of such two year period.

Pursuant to paragraph (2), this Article does not apply to income from research undertaken not in the public interest but primarily for the private benefit of a specific person or persons other than the person performing the research.

Article 24. STUDENTS AND TRAINEES

Paragraph (1) provides that an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein for the primary purpose of studying at a university or other recognized educational institution, securing training required to qualify him to practice a profession or professional specialty, or studying or doing research as a recipient of a grant, allowance, or award from a government, religious, charitable, scientific, literary, or educational organization, will be exempt from tax by that other Contracting State for a period not exceeding five taxable years from the date of his arrival in that other Contracting State on:

(1) gifts from abroad for the purpose of his maintenance, education, study, research or training;

(2) the grant, allowance, or award; and

(3) income from personal services performed in the other Contracting State not in excess of $3,000 or its equivalent in Israeli pounds for any taxable year.

Under paragraph (2), an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein as an employee of, or under contract with, a resident of the first-mentioned Contracting State, for the primary purpose of acquiring technical, professional, or business experience from a person other than that resident of the first-mentioned Contracting State or other than a person related to such resident, or studying at a university or other recognized educational institution in that other Contracting State, will be exempt from tax by that other Contracting State for a period not exceeding twelve consecutive months, on income from personal services not in excess of $7,500 or its equivalent in Israeli pounds.

Under paragraph (3), an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein for a period not exceeding one year, as a participant in a program sponsored by the other Contracting State, for the primary purpose of training, research, or study, will be exempt from tax by the other Contracting State with respect to his income from personal services in respect of such training, research, or study performed in that other Contracting State in an aggregate amount not in excess of $10,000 or its equivalent in Israeli pounds.

The monetary limits provided in paragraph (1), (2), or (3) are in addition to, and not in lieu of, other exemptions provided by the Code. Thus, an unmarried resident of Israel who is temporarily present in the United States for the primary purpose of studying at a university would be entitled to exclude $3,000 of income from the performance of personal services and, in addition, would be entitled to the personal exemption allowed by section 151 of the Code, as provided in section 873(b) of the Code.

The first sentence of paragraph (4) provides that the benefits provided in paragraph (1) and the benefits provided under Article 23 (Teachers), when taken together, may extend only for such period of time, not to exceed five taxable years from the date of the individual's arrival, as may reasonably or customarily be required to effectuate the purpose of the visit. The second sentence of paragraph (4) makes it clear that the benefits provided by Article 23 will not be available to an individual if, during the immediately preceding period, the individual enjoyed the benefits provided by paragraph (1). Thus, an Israeli individual who originally entered the United States for the purpose of becoming a student and received benefits under paragraph (1) must leave the United States and, if necessary, re-establish residence in Israel and then return at the invitation of the United States, a political subdivision or local authority thereof, or a university or other recognized educational institution for the primary purpose of becoming a teacher in order to take advantage of Article 23.

If an individual qualifies for the benefits of more than one of the provisions of Article 23 and this Article, such individual may choose the most favorable provision but may not claim the benefits of more than one provision in any taxable year as a means of avoiding the limitations provided. Thus, for example, an individual who comes to the other Contracting State for the primary purpose of studying may be able to qualify under either paragraphs (2) or (3) of this Article. However, he cannot combine the maximum exclusion limits in those two paragraphs to exclude $17,500 during the taxable year. If the individual becomes a citizen of, or acquires immigrant status in, the other Contracting State, that other Contracting State may tax the individual without regard to this Article. See paragraphs (3) and (4)(b) of Article 6 (General Rules of Taxation).

Article 25. INVESTMENT OR HOLDING COMPANIES

The Article provides that a corporation of one Contracting State deriving dividends, interest, royalties or capital gains from sources within the other Contracting State will not be entitled to the benefits of Articles 12 (Dividends), 13 (Interest), 14 (Royalties), or 15 (Capital Gains) if by reason of special measures the tax imposed on such corporation by the first-mentioned Contracting State with respect to such dividends, interest, royalties or capital gains is substantially less than the tax generally imposed by such Contracting State on corporate profits, and twenty-five percent or more of the capital of such corporation is held of record or is otherwise determined, after consultation between the competent authorities of the Contracting States to be owned, directly or indirectly, by one or more persons who are not individual residents of the first-mentioned Contracting State (or, in the case of an Israeli corporation, who are citizens of the United States). For purposes of applying this Article, it is intended that the requisite direct or indirect ownership be tested at the individual shareholder level. Existing Code provisions dealing with the taxation of capital gains do not make this Article applicable with respect to capital gains.

The purpose of this Article is to deal with potential abuse which could occur if one of the Contracting States provided preferential rates of tax for investment or holding companies. In the absence of this Article, residents of third countries could organize a corporation in the Contracting State extending the preferential rates for the purpose of making investments in the other Contracting State. The combination of low tax rates in the first Contracting State and the reduced rates or exemptions in the other Contracting State would enable the third country residents to realize unintended benefits.

Article 26. RELIEF FROM DOUBLE TAXATION

In order to avoid double taxation, each Contracting State agrees in this Article to provide to its citizens or residents a credit against its taxes for taxes paid by such persons to the other Contracting State.

The United States agrees to allow a United States citizen or resident as a credit against United States tax an appropriate amount of taxes paid or accrued to Israel in accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle of paragraph (1)). In addition, in the case of a United States corporation owning at least ten percent of the voting stock of an Israeli corporation from which it receives dividends in any taxable year, the United States will allow credit for the appropriate amount of taxes paid or accrued to Israel by the Israeli corporation paying such dividends with respect to the profits out of which such dividends are paid. The appropriate amount will be based upon the amount of tax paid or accrued to Israel, but the credit is not to exceed the limitations (for the purpose of limiting the credit to the United States tax on income from sources within Israel or on income from sources outside of the United States) provided by United States law for the taxable year. This provision does not require the United States to maintain a per-country or overall limitation in the future so long as the general principle of a foreign tax credit remains in effect. For the purpose of applying the United States credit in relation to taxes paid or accrued to Israel, the rules set forth in Article 4 (Source of Income) will be applied to determine the source of income and the taxes referred to in paragraphs (1)(b) and (2) of Article 1 (Taxes Covered) will be considered to be income taxes. Whether Israeli taxes are paid or accrued is determined under the rules of the Code. A taxpayer may, for any year, claim a foreign tax credit under the rules of the Code. In that case, he would forego the rules of the Convention that guarantee income tax status for the specified Israeli taxes.

Paragraph (2) details the treatment for United States tax purposes of compulsory loans to Israel made by United States citizens or residents or by a subsidiary of a United States corporation. If for any taxable year a United States citizen or resident takes a credit against tax for a compulsory loan to Israel (which is included as a tax under paragraph (1)(b)(v) of Article 1 (Taxes Covered)), whether paid by such citizen or resident or by a corporation 10 percent or more of the voting stock of which is owned by such citizen or resident, then any interest received on such loan is not to be included in taxable income and no deduction is to be allowed for any interest subsequently assessed or collected by the United States; upon repayment or recoupment of the principal of the loan, the amount of the value in United States dollars received shall be treated as a refund for the year the loan was made of taxes paid to Israel for such year equal to the basis for such loan, and the amount of any tax credit taken shall be recomputed, notwithstanding the operation of any law or rule of law; any such amount in excess of such basis shall be included in taxable income for the year the repayment or recoupment is made; and no interest will be assessed or collected by the United States on any amount of tax due for the year the loan was made except to the extent that interest was received from Israel on the loan. Thus, the United States, is to permit treatment of the compulsory loan payment as a creditable tax and will be entitled to its normal interest charges to the extent made on such loan, but not to exceed the amount actually received by the taxpayer.

Where the taxpayer has previously claimed an indirect credit for a compulsory loan payment made by a subsidiary corporation, the taxpayer at the time of payment of interest by Israel to the subsidiary will be considered to be the recipient of such interest. The amount of the interest will be considered a contribution to the capital of the subsidiary by the taxpayer. As under section 905(c) of the Code, the recomputation and payment of tax shall be made without regard to any otherwise applicable statute of limitations on assessments. The Secretary of the Treasury will prescribe regulations he deems necessary to carry out the purposes of this paragraph, including rules for determining whether an amount included as a tax under paragraph (1)(b)(v) of Article 1 (Taxes Covered) has been taken as a credit against tax.

Under paragraph (3), Israel will allow a resident of Israel as a credit against Israeli tax the appropriate amount of income taxes paid or accrued to the United States and, in the case of an Israeli corporation owning at least ten percent of the voting stock of a United States corporation from which it receives dividends in any taxable year, will also allow credit for the appropriate amount of taxes paid or accrued to the United States by the United States corporation paying such dividends with respect to the profits out of which such dividends are paid. The appropriate amount will be based upon the amount of tax paid or accrued to the United States but will not exceed that portion of Israeli tax which such resident's net income from sources within the United States bears to his entire net income for the same taxable year. For the purpose of applying the Israeli credit in relation to taxes paid or accrued to the United States, the rules set forth in Article 4 (Source of Income) will be applied to determine the source of income, and the taxes referred to in paragraphs (1)(a) and (2) of Article 1 (Taxes Covered) will be considered to be creditable taxes.

The saving clause in paragraph (3) of Article 6 (General Rules of Taxation) does not apply to this Article. Thus, the provisions of this Article may be relied upon a citizen or resident of a Contracting State.

Article 27. NONDISCRIMINATION

Paragraph (1) provides that a citizen of one Contracting State who is a resident of the other Contracting State will not be subject in that other Contracting State to more burdensome taxes than a citizen of that other Contracting State who is a resident thereof. The determination of whether there is more burdensome taxation is to be made by comparing the treatment of individuals who are in comparable positions. Thus, for example, a citizen of Israel who is a resident of the United States and who otherwise meets the requirements specified in section 911 of the Code would, under this Article, be eligible for the benefits of section 911 even though not a citizen of the United States.

Paragraph (2) provides that a permanent establishment which a resident of one Contracting State has in the other Contracting State will not be subject in that other Contracting State to more burdensome taxes than a resident of that other Contracting State carrying on the same activities. However, this does not obligate a Contracting State to grant to individual residents of the other Contracting State any personal allowances, reliefs, or deductions for taxation purposes on account of civil status or family responsibilities which it grants to its own individual residents.

Paragraph (3) prohibits one Contracting State from subjecting a corporation of such Contracting State the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State to any taxation or any requirement connected with taxation which is other or more burdensome than those applicable to corporations of the first-mentioned Contracting State carrying on the same activities, the capital of which is wholly or partly owned or controlled by one or more residents of the first-mentioned Contracting State.

Under paragraph (3) of Article 1 (Taxes Covered), the provisions of this Article extend to all taxes of every kind imposed at the national level.

The provisions of this Article do not override the right of the United States to impose the tax provided in Code section 897 (relating to gains derived by nonresident aliens or foreign corporations from U.S. real property interests).

The saving clause in paragraph (3) of Article 6 (General Rules of Taxation) does not apply to this Article. Thus, a Contracting State may not deny any rights conferred by this Article to its citizens and residents.

Article 28. MUTUAL AGREEMENT PROCEDURE

Under paragraph (1), when a resident or citizen of one Contracting State considers that action of one or both Contracting States results or will result for him in taxation not in accordance with the Convention, he may, notwithstanding the remedies provided by the national laws of the Contracting States, present his case to the competent authority of the Contracting State of which he is a resident or citizen. A resident (or citizen) of a Contracting State need not, although it is anticipated that in the normal situation he will, exhaust his other administrative or judicial remedies prior to resorting to the use of the mutual agreement procedure. If the claim is considered to have merit by the competent authority, that competent authority will endeavor to come to an agreement with the competent authority of the other Contracting State with a view to the avoidance of taxation not in accordance with the Convention.

Paragraph (2) requires the competent authorities of the two Contracting States to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the application of the Convention. In particular, the competent authorities may agree to the same attribution of industrial or commercial profits to a resident of one Contracting State and its permanent establishment situated in the other Contracting State; the same allocation of income, deductions, credits, or allowances between a resident of one Contracting State and a related person and to the readjustment of taxes imposed by each Contracting State to reflect such allocation; the same determination of the source of particular items of income; the same characterization of particular items of income; and the mode of application of Articles 15-A (Charitable Contributions) and 29 (Exchange of Information). The list of subjects of potential mutual agreement in paragraph (2) is not exhaustive; it merely illustrates the principles set forth in the paragraph.

Under paragraph (3), in implementing the provisions of this Article, the competent authorities may communicate with each other directly and, when advisable, meet together for an oral exchange of opinions.

Under paragraph (4), in cases in which the competent authorities reach an agreement, taxes will be imposed on such income, and refund or credit of taxes allowed, by the Contracting States in accordance with such agreement. This permits the issuance of a refund or credit notwithstanding procedural barriers otherwise existing under a Contracting State's law, such as the statute of limitations. However, it does not authorize additional taxes to be imposed after the statute of limitations has run.

Article 29. EXCHANGE OF INFORMATION

Paragraph (1) provides for a system of administrative cooperation between the competent authorities of the two Contracting States by requiring an exchange of information pertinent to carrying out the provisions of the Convention or preventing fraud or fiscal evasion in relation to the taxes which are the subject of the Convention. The competent authorities may exchange information in connection with tax compliance generally, not merely illegal acts or crimes. Information exchanged must be treated as secret and cannot be disclosed to any persons or authorities other than those concerned with the assessment, including judicial determination, or collection of the taxes which are the subject of the Convention. Thus, disclosure is not prohibited as a part of a public proceeding before a court or administrative body.

Paragraph (2) makes clear that a Contracting State is not obligated to carry out administrative measures at variance with the laws or the administrative practice of either Contracting State; to supply particulars which are not obtainable under the laws or in the normal course of the administration of either Contracting State; or to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

In making the determinations necessary under paragraph (2) a

Contracting State will use the standards it uses in the enforcement of its own laws by its administrative and judicial authorities, treating the tax of the Contracting State with respect to which a request relates as if it were a tax of the Contracting State requested to furnish the information and were being imposed by such Contracting State. Depositions of witnesses and copies of unedited original documents (including books, papers, statements, records, accounts, or writings) may be provided by the competent authority of a Contracting State if specifically requested by the competent authority of the other Contracting State. In addition, any information which may be furnished in accordance with this Article should not be withheld by reason of any doctrine of law under which international judicial assistance is not accorded in tax matters.

The exchange of information may be on either a routine basis or on request with reference to particular cases. The competent authorities may agree on the list of information to be furnished on a routine basis.

In an exchange of notes signed at the time of the signing of the Protocol, Israel noted that at the present time, its manpower resources and technical capabilities do not permit it to provide information on a routine basis with respect to U.S. residents receiving dividends, interest, and royalties from Israel, nor is it in a position to provide information not already existing in the Finance Minister's files. The Government of Israel, however, does intend to remedy its manpower and technical deficiencies so that it will be able to exchange the full range of information provided for in the Convention.

Article 30. DIPLOMATIC AND CONSULAR OFFICERS

This Article provides that nothing in the Convention will affect the fiscal privileges of diplomatic and consular officials under the general rules of international law or under the provisions of special agreements.

Article 31. ENTRY INTO FORCE

This Article and Article XVI of the Protocol provide that the Convention and the Protocol are subject to ratification and provide for the exchange of instruments of ratification. The Convention and Protocol will enter into force thirty days after the date of exchange of such instruments of ratification. The Convention shall first have effect as respects the rate of withholding of tax, to amounts paid on or after the first day of the second month following the date on which the Convention enters into force, and, as respects other taxes, to taxable years beginning on or after January 1 of the year following the date on which the Convention enters into force.

Article 32. TERMINATION

Paragraph (1) provides that the Convention will continue in force indefinitely, but that it may be terminated by either Contracting State at any time after five years from the date it enters into force. A Contracting State seeking to terminate the Convention must give at least six months' notice through diplomatic channels. If the Convention is terminated, such termination will be effective with respect to income of calendar years or taxable years beginning (or in the case of taxes payable at source, payments made) on or after April 1 next following the expiration of the six month period. It is intended that the reference to calendar years applies only to cases where the taxable year is the calendar year.

Under paragraph (2), the provisions of Article 21 (Social Secuity Payments) may be terminated by either Contracting State at any time after the Convention enters into force by prior notice given through diplomatic channels.

EXCHANGES OF NOTES

Three notes were exchanged at the time of the signing of the Protocol. A note dealing with exchanges of information is described in the explanation of Article 29 (Exchange of Information). A note dealing with procedures for certifying organizations in the Contracting State as eligible to receive deductible contributions is described in the explanation of Article 15-A (Charitable Contributions). The third note observed that during the negotiations, the Israeli delegation had stressed the need for provisions in the Convention, such as an investment credit, which would promote the flow of United States investment to Israel. While observing that the United States cannot, at the present time, agree to such a provision, the United States offered assurances that, should circumstances change, including the manner in which the United States taxes income from investments in Israel, the U.S. would be prepared to resume discussions with a view to incorporating provisions into the Convention which will minimize the interference of the United States tax system with incentives offered by Israel. These provisions would be consistent with United States tax policies regarding other developing countries.

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TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND JAMAICA FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME SIGNED AT JAMAICA ON MAY 21, 1980, AS AMENDED BY THE PROTOCOL SIGNED AT JAMAICA ON JULY 17, 1981

INTRODUCTION

In this technical explanation of the Convention between the United States and Jamaica signed on May 21, 1980, as amended by the Protocol signed on July 17, 1981 ("the Convention"), references are made to the U.S. Model Income Tax Convention of 1977 (the "U.S. Model") and to the extension in 1959 to Jamaica of the 1945 Income Tax Convention between the United States and the United Kingdom, as amended by Protocols of June 6, 1946, May 25, 1954 and August 16, 1957 ("the 1959 Convention"). These references are intended to put various provisions of the Convention into context. The technical explanation does not, however, provide a complete comparsion between the Convention and either the U.S. Model or the 1959 Convention. Moreover, neither the Convention nor the technical explanation is intended to have implications for the interpretation of the 1959 Convention.

The technical explanation is an official guide to the Convention. It reflects policies behind particular Convention provisions, as well as understandings reached with respect to the interpretation and application of the Convention.

Article 1. PERSONAL SCOPE

Article 1 identifies the persons who come within the scope of the Convention. Paragraph 1 provides that, in general, the Convention applies to persons who are residents of one or both of the Contracting States. The term "resident" is defined in Article 4 (Residence). The Convention may also apply to residents of third States. For example, paragraph 6 of Article 10 (Dividends) covers certain dividends derived by residents of third States and Article 27 (Exchange of Information) may apply to an exchange of information concerning residents of third States.

Paragraph 2 provides that the Convention shall not restrict any exclusion, exemption, deduction, credit or other allowance provided by the laws of either Contracting State or by any other agreement between the Contracting States. Thus, if a deduction would be allowed under the Internal Revenue Code of 1954 ("the Code") for an item in computing the taxable income of a Jamaican resident, such deduction is generally available to such person in computing taxable income under the Convention. Paragraph 2 does not, however, authorize a taxpayer to make inconsistent choices between rules of the Code and rules of the Convention. Thus, if a taxpayer claims the benefits of a provision of the Convention, he must use the rules of the Convention relevant to such benefit, and must use such rules consistently. In no event, however, are the rules of the Convention to increase U.S. tax liability from what that liability would be if there were no convention.

Paragraph 3 contains the traditional "saving clause" under which each Contracting State reserves the right to tax its residents, as determined under Article 4, as if the Convention had not come into effect. In the case of the United States, the "saving clause" applies to former citizens as well as to current citizens. Thus, a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of income tax will continue to be subject to U.S. income tax, in accordance with the provisions of section 877 of the Code, but only for a period of ten years following the loss of citizenship. This point is clarified by Article I of the Protocol.

Paragraph 4 sets forth certain exceptions to the saving clause. These exceptions are, in general, necessary to assure that provisions of the Convention intended to reduce a resident's tax liability to his country of residence fulfill their intended objective. Subparagraph (a) provides that the saving clause does not affect the benefits provided under paragraphs 1(b) and 4 of Article 19 (Pensions, etc.) and Articles 24 (Relief from Double Taxation), 25 (Non-Discrimination) and 26 (Mutual Agreement Procedure). Thus, notwithstanding the saving clause, the benefits of these Articles are available to residents and citizens of a Contracting State, as provided in the Articles.

Subparagraph (b) of paragraph 4 provides a second category of exceptions to the saving clause for persons who are residents of a Contracting State but are not citizens of that State and do not have immigrant status in that State. This second category of exceptions includes benefits conferred under Articles 20 (Government Service), 21 (Students and Trainees), 22 (Teachers and Researchers) and 28 (Diplomatic Agents and Consular Officers).

Article 2. TAXES COVERED

Paragraph 1 states that the Convention applies to taxes on income imposed by a Contracting State. Paragraph 1 is not intended either to broaden or limit paragraph 2, which provides that the Convention shall apply to the following Jamaican taxes: the Jamaican income tax, company profits tax and transfer tax.

Thus, paragraph 2 does not encompass the Jamaica bauxite production levy. It is not intended that the omission of the production levy from paragraph 2 should have any implications for the U.S. tax treatment of such levy.

Paragraph 2 also designates the existing United States taxes to which the Convention shall apply. These taxes are the Federal income taxes imposed by the Code, but excluding the accumulated earnings tax (Code section 531), except as provided in paragraph 5 of Article 10 (Dividends), and the personal holding company tax (Code section 541). Thus, this paragraph and paragraph 5 of Article 10 restrict the application of the accumulated earnings tax in the case of certain Jamaican tax incentive companies and certain companies controlled by residents of Jamaica. See the discussion of paragraph 5 of Article 10 below. Paragraph 2 does not cover the excise tax on insurance premiums paid to foreign insurers, the excise tax with respect to private foundations, or U.S. social security taxes.

Except for Article 25 (Non-Discrimination), the Convention does not apply to taxes on capital, and it applies to taxes imposed only at the national level. Capital taxes are not generally covered by this Convention because neither State currently imposes capital taxes.

Paragraph 3 provides that the Convention shall also apply to any taxes imposed subsequent to May 21, 1980, which are identical or substantially similar to the taxes existing on that date and covered by the Convention. The competent authorities agree to notify each other of any significant changes in their respective tax laws and of any official published material relating to the application of the Convention including this technical explanation.

Paragraph 3 also provides that the Convention shall apply to a tax imposed by Jamaica in lieu of the Jamaican income tax or company profits tax covered by paragraph 2 (b). As explained in the Exchange of Notes signed on May 21, 1980, such a tax must meet the requirements of Code section 903 to be covered by the Convention.

Paragraph 4 provides that the Convention applies to taxes of all kinds imposed at all levels of government for the purposes of Article 25 and to all national taxes for the purposes of Article 27 (Exchange of Information and Administrative Assistance).

Article 3. GENERAL DEFINITIONS

Paragraph 1 defines the principal terms used in the Convention. Unless the context otherwise requires, a term defined in this paragraph has a uniform meaning throughout the Convention. A number of important terms are, however, defined in other Articles. For example, the terms "resident" and "permanent establishment" are defined in Articles 4 (Residence) and 5 (Permanent Establishment), respectively, and the terms "dividends," "interest," and "royalties" are defined in Articles 10 (Dividends), 11 (Interest) and 12 (Royalties), respectively.

Paragraph 1 (a) of this Article defines the term "person" to include an individual, a partnership, a company, an estate, a trust and any other body of persons. The term "company" means any body corporate or any other entity which is treated as a body corporate for tax purposes.

The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean an enterprise or undertaking carried on by a resident, as defined by Article 4, of the United States or Jamaica, as the context requires.

The term "international traffic" means any transport by a ship or aircraft except where such transport is solely between places in the other Contracting State. Thus, for example, coastal shipping along the Atlantic coast of the United States is not international traffic. However, if a ship operated by a resident of Jamaica transports goods from Canada to the United States, leaving some of the goods in New York and the remainder in Norfolk, the entire transport would be international traffic. The definition of international traffic is relevant for purposes of Article 8 (Shipping and Air Transport).

The term "competent authority" is defined in paragraph 1(e) to mean, in the case of the United States, the Secretary of the Treasury or his delegate. The Secretary has delegated the general authority to act as competent authority to the Comissioner of Internal Revenue Service, who has redelegated such authority to the Assistant Commissioner (Compliance), with the concurrence, in certain cases, of the Assistant Commissioner (Technical). The Assistant Commissioner (Compliance) has redelegated authority to the Director of International Operations to administer programs for routine and specific exchanges of information and mutual assistance in collection and to the Director, Examination Division, to administer programs for simultaneous and industrial exchanges of information.

The term "United States" is defined to mean the United States of America and, when used in a geographical sense, includes the States and the District of Columbia, the U.S. territorial water and any area outside the States and the District of Columbia which, in accordance with international law and the laws of the United States, is an area within which the rights of the United

States with respect to the natural resources of the seabed and subsoil may be exercised.

The term "Jamaica" means the island of Jamaica, the Morant Cays the Pedro Cays and their Dependencies. When used in a geographical sense "Jamaica" includes the territorial waters of Jamaica and any area outside such territorial waters which in accordance with international law and the laws of Jamaica is an area with in which the rights of Jamaica with respect to the natural resources of the seabed and subsoil may be exercised.

The term "Contracting State" is defined to mean the United States or Jamaica, as the context requires.

A "national" of the United States is defined as a citizen of the United States as well as any company, association or other entity deriving its status as such from the laws of the United States, or of any political subdivision. A "national" of Jamaica is defined as a citizen of Jamaica, and any company, association, or other entity, such as a trust, deriving its status as such from the laws of Jamaica. The term "national" is used in Articles 20 (Government Service), 25 (Non-Discrimination) and 26 (Mutual Agreement Procedure).

Paragraph 2 provides that in the case of a term not defined in the Convention the domestic tax law of the Contracting State applying to the Convention shall control, unless the context in which the term is used requires a definition independent of domestic tax law or the competent authorities reach agreement on a meaning pursuant to Article 26 (Mutual Agreement Procedure). The term "context" refers to the purpose and background of the provisions in which the term appears.

Pursuant to the provisions of Article 26, the competent authorities of the Contracting States may resolve by mutual agreement any difficulties or doubts as to the interpretation or application of the Convention. An agreement by the competent authorities with respect to the meaning of a term used in the Convention would supercede conflicting meanings in the domestic laws of the Contracting States.

Article 4. RESIDENCE

This Article sets forth rules for determining the residence of individuals, companies, and other persons for purposes of the Convention. Article 4 is important because, except as otherwise provided, only a resident of a Contracting State may claim benefits under the Convention. And, a determination of residence under this Article applies for all other provisions of the

Convention. In general, the determination of residence begins with a person's liability to tax as a resident under the respective taxation laws of the Contracting States. Thus, a person who, under those laws, is a resident of one Contracting State need look no further. However, the Convention definition is also designed to assign residence to one State or the other for purposes of the Convention in circumstances where each of the States believes a person to be a resident. The Convention definition is, of course, exclusively for purposes of the Convention.

The term "resident of Jamaica" is defined as a company (as defined in paragraph 1(b) of Article 3 (General Definitions) whose business is managed and controlled in Jamaica and any other person (except a company) resident in Jamaica for purposes of its tax.

Similarly, the term "resident of the United States" is defined as a person (except a company) resident in the United States for purposes of its tax. This includes a resident alien individual, who is subject to tax by the United States on his worldwide income, or an alien present in the United States who makes an election under Code section 6013(g) or (h), as well as a resident U.S. citizen. The term also includes a company which is created or organized under the laws of the United States or a political subdivision thereof.

An individual is not automatically a resident of the United States or Jamaica for the purposes of this Convention if he is a citizen of either State. To be a resident of a Contracting State for purposes of the Convention, he must be subject to tax in that State on account of his residence therein. Thus, an individual will be considered to be a U.S. resident if, without regard to his citizenship, he would be taxable by the United States on his worldwide income as a resident. Residence for this purpose is to be determined in accordance with the principles of Treasury regulations under section 871 of the Internal Revenue Code.

Paragraph 1 of this Article also provides that a partnership, estate, or trust is a resident of a Contracting State only to the extent that the income derived by such person is subject to tax by such Contracting State as the income of a resident. For example, under United States law, a partnership is never, and an estate or trust is often not, taxed as such. Thus, under the Convention, a partnership, estate, or trust will be treated as a resident of the United States only to the extent that income derived by such partnership, estate, or trust is subject to tax by the United States as the income of a U.S. resident. Similarly, if a resident of Jamaica and a resident of a third State form a partnership, and the partnership derives dividends from the

United States, the limitation of U.S. tax under the provisions of Article 10 (Dividends) applies only to the dividends of the partner resident in Jamaica. However, the fact that a charitable organization or pension fund is generally exempt from tax by the Contracting State in which it is organized is not to be construed to deny such entity's status as a resident of that State under the Convention.

Paragraph 2 provides a series of tie-breaking rules for assigning residence to an individual who under paragraph 1 is a resident of both Contracting States. The first test depends upon where the individual has a permanent home available. If this test is inconclusive because the individual has a permanent home in both States or in neither of them, he is considered a resident of the State which is the center of his vital interests; i.e., the State with which his personal and economic relations are closer. If such a center cannot be determined, residence is where the individual has an habitual abode. If he has an habitual abode in both States or in neither of them, he is deemed to be a resident of the State of which he is a national. Should the individual be a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question of residence by mutual agreement under the authority of Article 26 (Mutual Agreement Procedure).

Paragraph 3 provides that a company which under paragraph 1 is a resident of both Contracting States (i.e., it is incorporated in the United States and has its place of effective management in Jamaica) shall be considered to be outside the scope of the Convention except for purposes of paragraph 2 of Article 10 (Dividends) in the case of dividends paid by such a company, Article 25 (Non-Discrimination), Article 26 (Mutual Agreement Procedure), Article 27 (Exchange of Information and Administrative Assistance) and Article 29 (Entry into Force). Thus, such a corporation is generally taxable as a resident by both Contracting States pursuant to their respective taxation laws. This paragraph differs from the U.S. Model Income Tax Convention which provides that a company resident in both contracting states is considered to be a resident of the contracting state under whose laws it was organized.

Paragraph 4 provides that if under paragraph 1 a person, other than an individual or a company, is a resident of both Contracting States, the competent authorities shall endeavor to agree on a single residence for such person and on how the Convention applies to such person. This provision applies to persons such as partnerships, trusts and estates.

Paragraph 5 provides that where income otherwise eligible for relief from source basis tax under the Convention (e.g., under

Articles 7 (Business Profits), 8 (Shipping and Air Transport), 10 (Dividends), 11 (Interest) and 12 (Royalties)), is denied such source basis benefits if the income is taxable to a person in the other Contracting State only if, and to the extent, it is remitted to or received by that person. For example, in certain cases individuals who are residents of Jamaica are not taxable by Jamaica on foreign source investment income, unless it is remitted to or received by them in Jamaica. If such income were received outside of Jamaica, or accumulated by the payer, the Jamaican resident would not be subject to Jamaican tax on that income. Thus, paragraph 5 provides that the reductions in rates or exemptions from U.S. tax otherwise provided to such a person by the Convention do not apply to the extent such items of income are not remitted to or received by such person in the calendar year the income accrues. Otherwise, the United States would be foregoing tax where double taxation does not in fact occur. Note that paragraph 5 does not deny source basis tax benefits if the income is remitted to or received in the other Contracting State by the end of the calendar year following the calendar year in which the income accrued.

Article 5. PERMANENT ESTABLISHMENT

This Article defines the term "permanent establishment," which is relevant particularly to the taxation of business profits under Article 7 (Business Profits). Paragraph 1 defines the term "permanent establishment" as a fixed place of business through which the business of an enterprise is wholly or partly carried on. Paragraph 2 provides an illustrative list of fixed places of business which constitute a permanent establishment. The list includes: a place of management; a branch; an office; a factory; a workshop; a store or premises used as a sales outlet; a warehouse, in relation to a person providing storage facilities for others; a mine, an oil or gas well, a quarry or any other place of extraction of natural resources. The term "place of management" is used in the OECD Model Income Tax Convention. Since a place of management would in most cases require an office, which is specifically listed in paragraph 2, the insertion of "place of management" will generally not cause a fixed placed of business to be a permanent establishment if it would not otherwise be a permanent establishment. The subparagraph (f) reference to a premises used as a "sales outlet" does not mean that premises used by an enterprise for the mere delivery of goods is a permanent establishment; additional significant activity by the enterprise at the premises, such as the negotiation of sales and delivery of goods, is necessary for the premises to constitute a "sales outlet" and a permanent establishment of the enterprise.

Paragraph 2(i) provides that a building site or construction, assembly, installation, or dredging project, or a drilling rig or ship used for the exploration of natural resources within a Contracting State constitutes a permanent establishment, but only if the project or activity continues within that State for one or more periods totaling 183 days in a 12 month period. For a permanent establishment to exist in any one year, however, the site, project, or activity must continue for at least 30 days in that year. A series of contracts or projects which are interdependent both commercially and geographically is to be treated as a single project for the purpose of applying the 183 day test.

Paragraph 2(j) provides that the furnishing of services, including consultancy, management, technical, and supervisory services within a Contracting State by an enterprise through employees or other personnel constitutes a permanent establishment but only if: the activities continue within that State for a period or periods aggregating more than 90 days in any 12 month period (and for 30 days or more in the taxable year); or, the services are performed within that State for a related enterprise. Thus, if a calendar year taxpayer provides consulting services to several unrelated companies in Jamaica for 25 days during December of year 1 and for 70 days during January-November of year 2, the taxpayer will be considered, under paragraph 2(j), to have a permanent establishment in Jamaica in year 2.

Paragraph 2(k) provides that the maintenance of substantial equipment or machinery within a Contracting State constitutes a permanent establishment, but only if such equipment or machinery is maintained within that State for a period exceeding 120 consecutive days (and for 30 days or more in the taxable year).

Paragraph 3 overrides paragraphs 1 and 2 to provide that a fixed place of business may be used for one or more of the following activities and not be a permanent establishment:

(a) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise, other than goods or merchandise held for sale by such enterprise in a store or premises used as a sales outlet;

(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery, other than goods or merchandise held for sale by such enterprise in a store or premises used as a sales outlet;

(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

(e) the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research or for similar activities which have a preparatory or auxiliary character, for the enterprise.

It should be noted that the phrase "other than goods or merchandise held for sale by such enterprise in a store or premises used as a sales outlet" in paragraph (3)(a) and (b) narrows somewhat these exceptions to the definition of permanent establishment when a person has a sales outlet. The term "sales outlet" is intended, however, to mean a place of business where the enterprise conducts activities which contribute significantly to the conclusion of sales, not a place where goods are merely delivered. The reference in subparagraph (e) to advertising, scientific research and supply of information is not intended to suggest that such activities are always auxiliary or that other activities cannot be auxiliary.

Paragraph 4 provides that if an enterprise of a Contracting State does not have a permanent establishment in the other Contracting State under paragraphs 1, 2 and 3, but goods or merchandise are either subjected to processing in that other Contracting State by another person (whether or not purchased in that other Contracting State), or are purchased in that other Contracting State (and such goods or merchandise are not subject to processing outside that other Contracting State), then such enterprise shall be considered to have a permanent establishment in that other Contracting State to the extent that all or part of such goods or merchandise is sold by or on behalf of such enterprise for use, consumption, or disposition in that other Contracting State.

Paragraphs 5 and 6 apply to the permanent establishment implications of employees and agents. Under paragraph 5 a person (other than an agent of an independent state to whom paragraph 6 applies) acting in a Contracting State on behalf of an enterprise in the other Contracting State shall be deemed to be a permanent establishment in the first-mentioned State of that enterprise if:

(a) he habitually exercises in that State an authority to conclude contracts in name of the enterprise, unless his activities are limited to those listed in paragraph 3 and are not described in paragraph 4; or,

(b) he habitually maintains in that State a stock of goods or merchandise from which he regularly delivers goods on behalf of the enterprise and additional activities conducted in that State on behalf of the enterprise have contributed to the conclusion of the sale of such goods or merchandise.

Thus, if a U.S. company that does not have a fixed place of business in Jamaica hires a person who does not have the power to conclude contracts on behalf of the company but who during a taxable year participates materially in Jamaica in the negotiation of contracts for the sale of goods on behalf of the company to residents of Jamaica, and regularly delivers such goods in Jamaica to the purchasers on behalf of the company, the person is considered to be a permanent establishment of the U.S. company if he habitually maintains in Jamaica a stock of goods from which he makes the deliveries.

Paragraph 6 provides that if an enterprise of one Contracting State merely carries on business in the other Contracting State through a broker or any other agent of independent status acting in the ordinary course of his business, the enterprise will not thereby be considered to have a permanent establishment in that other State. Paragraph 6 also provides, however, that such broker or agent will not be considered independent, and paragraph 6 shall not apply, if all his activities are devoted wholly, or almost wholly, on behalf of that enterprise and the transactions between the two are not conducted under arm's-length conditions.

Paragraph 7 provides that the fact that a company which is a resident of one Contracting State either controls or is controlled by a company which is a resident of the other Contracting State, or which is a resident of any State and carries on business in that other State, does not automatically render either company a permanent establishment of the other.

Article 6. INCOME FROM IMMOVABLE PROPERTY (REAL PROPERTY)

Paragraph 1 of this Article provides that income derived by a resident of a Contracting State from real property, including income from agriculture and forestry, may be taxed in the other Contracting State if the property is situated in that other State. This right to tax does not depend on whether the income is derived through a permanent establishment in that other State. Also, the Convention does not limit the amount of tax imposed by the other Contracting State on the real property income. In contrast, Article IX of the 1959 Convention imposes a limitation of 15 percent on the tax imposed on certain royalties in respect of the extraction of natural resources. Income derived from real property includes income from rights such as an overriding royalty or a net profits interest in a natural resource. Income in the form of rights to explore for or exploit natural resources which a person receives as compensation for services (e.g., exploration services) is, however, subject to the provisions of Article 7 (Business Profits), 14 (Independent Personal Services) or 15 (Dependent Personal Services), as the case may be, rather than the provisions of this Article.

Paragraph 2 defines real property as having the meaning it has under the laws of the Contracting State in which the property is situated. Paragraph 2 also provides that certain other types of property are included in the Convention definition of real property, notwithstanding domestic law definitions.

Paragraph 3 provides that the basic rule in paragraph 1 applies to income derived from the direct use, letting, or any other use of real property. Paragraph 4, provides that the rules of this Article apply to the income from immovable property of an enterprise or from property used for the performance of independent personal services.

Paragraph 5 of the U.S. Model, which provides a binding election to be taxed on a net basis, was omitted from the Convention; such an election is available under both U.S. and Jamaican domestic law.

Article 7. BUSINESS PROFITS

This Article provides rules for the taxation by a Contracting State of income from business activity carried on in that State by a resident of the other Contracting State.

Paragraph 1 provides that the business profits, as defined in paragraph 7, of an enterprise of a Contracting State shall be taxable only by that State except to the extent that such profits are attributable to a permanent establishment through which the enterprise carries on business in the other Contracting State. The term "permanent establishment" is defined in Article 5 (Permanent Establishment).

Paragraph 2 provides that the profits to be attributed to a permanent establishment are those which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions. The term profits "attributable to" a permanent establishment means that the limited "force-of-attraction" rule of Code section 864(c)(3) does not apply for U.S. tax purposes under the Convention. Profits may, however, be from sources within or without a Contracting State and be "attributable to" a permanent establishment. Thus, items of income described in section 864(c)(4)(B) of the Code which are attributable to a permanent establishment in the United States are subject to tax by the United States. In contrast, paragraph (1) of Article III of the 1959 Convention allows the United States to tax industrial and commercial profits only from sources within the United States.

Paragraph 3 provides that there shall be allowed as deductions those expenses incurred for the purposes of the permanent establishment, whether incurred in the State where the permanent establishment is located or elsewhere. While administrative expenses, research and development expenses, interest, and other expenses are not specifically listed in paragraph 3, such expenses are deductible pursuant to paragraph 3 wherever incurred if, of course, they are substantiated.

Paragraph 4 provides that the mere purchase by a permanent establishment of goods or merchandise for the enterprise shall not result in profits being attributed to the permanent establishment. Paragraph 5 provides that the same method for determining the profits attributable to a permanent establishment shall be used each year unless there is good and sufficient reason to change. In the United States, such a change may be a change of accounting method requiring the approval of the Internal Revenue Service.

Paragraph 6 provides that where business profits include items of income dealt with separately in other Articles of the Convention, then the provisions of those separate Articles override the provisions of Article 7. Thus, for example, the taxation of income from international shipping and transport dealt with in Article 8 (Shipping and Air Transport) is governed by that Article and not by Article 7. Similarly the taxation of dividends, interest, and royalties is controlled by Articles 10 (Dividends), 11 (Interest), and 12 (Royalties); however, those Articles provide that where dividends, interest, or royalties derived by a resident of a Contracting State are attributable to a permanent establishment of that resident in the other Contracting State, then the provisions of this Article, or Article 14 (Independent Personal Services), shall apply.

Paragraph 7 provides a definition of "business profits." Such profits are defined to mean income derived from the conduct of any trade or business, including the rental of tangible personal property and the furnishing of personal services of another person. Paragraph 7 clarifies that income derived from performance of personal services either as an employee or in an independent capacity is not within the definition of "business profits." Thus, as a generally matter, rental income derived by a resident of one Contracting State may not be taxed by the other Contracting State except to the extent attributable to a permanent establishment in the latter State. See, however, paragraph 3 of Article 12 (Royalties) which provides that payments for the use of, or the right to use, copyrights for work such as films are taxable in the Contracting State in which they arise, subject to the limitations imposed by Article 12, whether or not the owner of the payments has a permanent establishment in that State.

Article 8. SHIPPING AND AIR TRANSPORT

Paragraph 1 provides that profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only by that Contracting State. International traffic is defined in paragraph 1(d) of Article 3 (General Definitions). Thus, the other Contracting State may not tax such profits even if they are attributable to a permanent establishment of the enterprise in that other State. Unlike the 1959 Convention provision concerning shipping and aircraft (Article V), Article 8 does not list as a standard the place of registration of the ship or aircraft.

Paragraphs 2 and 3 clarify what income is to be considered profits from the operation of ships or aircraft. Paragraph 2 states that income from the operation of ships or aircraft in international traffic includes profits from the rental of ships or aircraft if operated in international traffic by the lessee, or if such rental profits are incidental to operating profits. Such "incidental" rental profits may include rents from bareboat charters.

Paragraph 3 states that profits of an enterprise of a Contracting State from the use, maintenance or rental of containers, and related equipment for the transport of containers, used for the transport of goods or merchandise in international traffic are taxable only by the Contracting State in which the enterprise is resident.

Paragraph 4 provides that the provisions of paragraphs 1 and 3 apply to profits from the participation in a pool, a joint business, or an international operating agency.

Article 9. ASSOCIATED ENTERPRISES

This Article confirms the power of the United States under

Code section 482 to allocate items of income, deductions, credits, or allowances in certain cases. The Article also authorizes a Contracting State to, for example, reduce a proposed allocation by that State or make an adjustment of income or deductions corresponding to a proposed allocation by the other State to the extent necessary to prevent double taxation of income by the two Contracting States.

Pursuant to paragraph 1, if an enterprise subject to tax by a Contracting State and any other enterprise, whether or not a resident of a Contracting State, make arrangements or impose conditions which differ from those which would be made between independent enterprises, any income, deductions, credits or allowances which would, but for those conditions, have accrued to one of the enterprises may be taken into account in computing the amount included in the profits of that enterprise and taxed accordingly.

Paragraph 2 provides that where a redetermination has been made by a Contracting State to the income of an enterprise, then the other Contracting State shall, if it agrees with such redetermination and if necessary to avoid double taxation by the two Contracting States, make a corresponding adjustment to the income of the related enterprise in such other Contracting State. In the event that the Contracting State disagrees with such redetermination, then the competent authorities shall endeavor to resolve the matter in accordance with Article 26 (Mutual Agreement Procedure).

Paragraph 3 provides that an enterprise is related to another enterprise if either enterprise owns or controls directly or indirectly the other, or if any third person or persons own or control, directly or indirectly, both. The term "control" is defined broadly to include all forms of control, however exercisable.

Article 10. DIVIDENDS

Under paragraph 1 dividends paid by a company which is a resident of a Contracting State to a shareholder resident by the other Contracting State may be taxed by that other State. Such dividends may also be taxed by the State of which the company paying the dividends is a resident, but such tax may not be in excess of the rates specified in paragraph 2, which is amended by the 1981 Protocol: 10 percent of the dividends, where the beneficial owner is a company which owns, directly or indirectly, at least 10 percent of the voting stock of the company paying the dividends; and, 15 percent of the dividends in all other cases. Paragraph 2 does not affect the taxation of the company's profits out of which the dividends are paid.

Paragraph 3 defines "dividends", for the purposes of Article 10, as income from shares or other rights (not debt-claims) participating in profits, and income from other corporate rights taxed in the same way as income from shares under the tax law of the State of which the company making the distribution is a resident.

Paragraph 4 provides that where dividends otherwise taxable at source at 10 or 15 percent as provided in paragraph 2 are attributable to a permanent establishment or fixed base of the beneficial owner in the Contracting State of which the company paying the dividends is a resident, then the dividends are taxable by that State in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), rather than under the provisions of paragraph 2 of this Article.

Paragraph 5 provides that the income of a Jamaican company derived from manufacture in Jamaica of approved products under the tax incentive legislation of Jamaica shall not be subject to the United States accumulated earnings tax. Generally, these companies are incorporated in Jamaica to manufacture approved products in Jamaica and to participate in a "pioneering activity." Such companies are subject to a reduced corporate profits tax by Jamaica. Paragraph 5 also provides that any company which is a resident of Jamaica shall be exempt from United States accumulated earnings tax if individuals (other than U.S. citizens) who are resident of Jamaica control, directly or indirectly, throughout the last half of the taxable year more than 75 percent of the entire voting power in that company.

Paragraph 6 provides that, as a general rule, a Contracting State may not impose tax on dividends paid by a company which is a resident of the other Contracting State. There are two exceptions to this rule: where dividends are paid to a resident of the first-mentioned State; and where dividends are attributable to a permanent establishment or fixed base in the first State. For example, if a corporation created under the laws of Jamaica is doing business in the United States and pays dividends, those dividends may be taxed by the United States if: paid to a resident (or citizen) of the United States; or if attributable to a permanent establishment or a fixed base in the United States. Thus, dividends paid by a Jamaican company with a permanent establishment in the United States, which has at least 50 percent of its gross income from all sources attributable to such permanent establishment, shall not be taxed by the United States even if such dividends are paid to a resident of a third State. See, however, Article 17 (Limitations on Benefits) for circumstances where this exemption from U.S. tax may not apply. Also this rule (and the rest of Article 10) is subject to the saving clause of paragraph 3 of Article 1 (Personal Scope).

Finally, in the case of dividends paid by a company resident in a third State, see paragraph 3 of Article 23 (Other Income).

Article 11. INTEREST

This Article concerns the taxation by a Contracting State of interest arising in that State and derived and beneficially owned by a resident of the other Contracting State. Paragraph 1 provides that the other Contracting State may tax such interest. Paragraph 2 provides that the Contracting State in which the interest arises may also tax the interest, but the tax may not exceed 12.5 percent of the gross amount of the interest. There is no general interest article in the 1959 Convention. Thus, Jamaican and United States tax on interest derived by a resident of the other State is, in general, not limited by the 1959 Convention.

Paragraph 3 provides two exceptions to the rule in paragraph 2. Pursuant to these exceptions, interest is exempt from tax by the Contracting State in which the interest arises if it is derived by: the other Contracting State or an instrumentality thereof (including certain specificied entities such as the Bank of Jamaica and the U.S. Federal Reserve Banks, and such other institutions of the Contracting States as are specified in agreements entered into under Article 26 (Mutual Agreement Procedure)), or a resident of the other Contracting State with respect to debt obligations guaranteed or insured by that State or an instrumentality thereof.

Paragraph 4 contains the definition of interest found in the U.S. Model. Paragraph 4 omits, however, the U.S. Model statement that penalty charges for late payment shall not be regarded as interest.

Paragraph 5 provides that interest attributable to a permanent establishment or fixed base which the beneficial owner of the interest, being a resident of a Contracting State, maintains in the other Contracting State is taxable in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, rather than under this Article.

Paragraph 6 identifies the place where interest is deemed to arise. Interest is deemed to arise in a Contracting State when the payer is that State, a political subdivision, a local authority, or a resident of that State. If, however, the interest is incurred in connection with a permanent establishment or fixed base in a Contracting State and such interest is allowable as a deduction in computing tax liability of the permanent establishment or fixed base in that State, then the interest is deemed to arise in that State, regardless of the payer's State of residence.

If an excessive amount of interest is paid by reason of a special relationship between the payer and beneficial owner of interest, or between both of them and a third person then, pursuant to paragraph 7, the provisions of Article 11 shall only apply to the portion of the payment which would have been agreed upon in the absence of such special relationship. The excess amount may be taxed by each Contracting State, in accordance with its own law, including the Convention where applicable. In the case of the United States, the excess amount may, for example, be taxed as a dividend, in which case the provisions of Article 10 (Dividends) may apply.

Note that Article 11 does not preclude the application by the United States of tax on interest paid to a beneficial owner resident in Jamaica by a company resident in Jamaica or a third State if the interest arises in Jamaica and the requirements of the Code for the imposition of such tax are satisfied. The United States tax on such interest beneficially owned by a Jamaican resident is limited by paragraph 1 to 12.5 percent.

Article 12. ROYALTIES

Paragraph 1 provides that royalties arising in a Contracting State which are derived and beneficially owned by a resident of the other Contracting State may be taxed by that other State. Paragraph 2 provides that the State in which the royalty arises may also tax the royalty, but the tax may not exceed 10 percent of the royalty. Paragraph 3 contains the definition of royalty found in the U.S. Model, but treats as royalties payments received as consideration for the use of cinematograph films, or films or tapes used for radio or television. Also, paragraph 3 specifies that the term "royalties" does not include payments for the use of tangible personal property. Such payments are taxable as provided in Articles 7 (Business Profits) or 14 (Independent Personal Services), as the case may be. The term "royalties" does not encompass management fees, which are covered by the provisions of Article 7 or 14, or payments under a bona fide cost-sharing arrangment. Technical service fees may be royalties in cases where the fees are periodic and dependent upon productivity or a similar measure.

Paragraph 4 provides that royalties attributable to a permanent establishment or fixed base which the beneficial owner of the royalties being a resident of a Contracting State maintains in the other Contracting State are taxable in accordance with the provisions of Article 7 or Article 14, as the case may be, rather than under this Article.

If an excessive amount of royalty is paid by reason of a special relationship between the payer and the beneficial owner of the royalty, or between both of them and a third person, then pursuant to paragraph 5 the provisions of Article 12 shall only apply to the portion of the payment which would have been agreed upon in the absence of the special relationship. The excess amount may be taxed by each Contracting State, in accordance with its own law, including the Convention where applicable. In the case of the United States, the excess amount may, for example, be taxed as a dividend, in which case the provisions of Article 10 (Dividends) may apply.

Paragraph 6 identifies the State in which royalties are deemed to arise. The general rule is that royalties arise in a Contracting State when the payer is that State itself, a political subdivision or local authority, or a resident of that State. Payments for the use of or the right to use property or rights in a Contracting State are deemed, however, to arise in the State in which they are used. This rule reflects the U.S. statutory rule, which sources royalties in the State in which the property or rights are used. Thus, if a U.S. resident licensor receives royalties from a resident of Jamaica for the use of a patent in Jamaica or in a third State the royalty will be deemed to arise in Jamaica. If, however, the Jamaican resident uses the patent in the United States, the royalty will be deemed to arise in the United States. These rules are relevant for purposes of calculating the U.S. foreign tax credit for Jamaican income taxes. See paragraphs 1 and 3 of Article 24 (Relief from Double Taxation).

Article 13. CAPITAL GAINS

Paragraph 1 provides that gains from alienation of real property may be taxed by the Contracting State in which the property is situated. In that connection, paragraph 5 further provides that gains from the alienation of stock of a company or an interest in a partnership, trust or estate, the value of which is derived principally from real property may also be taxed by the Contracting State in which such real property is situated. In determining whether the value of stock of a company or an interest in a partnership, trust or estate is principally from real property, one takes into account any stock or interests in entities the direct disposition of which would be subject to tax under paragraph 5.

Paragraph 2 provides that a Contracting State may tax gains from the alienation of movable property forming part of the property of a permanent establishment or pertaining to a fixed base in that State which belongs to a resident of the other Contracting State.

Paragraph 3 further provides that gains derived by an enterprise of a Contracting State from the alienation of ships, aircrafts, or containers operated in international traffic shall be taxable only in that State (i.e., the State of residence).

Paragraph 4 allows Jamaica to impose its transfer tax upon the alienation of property pursuant to its Transfer Tax Act, as in effect on May 21, 1980.

Paragraph 6 provides that alienation of any property not referred to in paragraphs 1, 2, 3, 4 and 5 shall be taxable only in the Contracting State of which the alienator is resident.

Paragraph 7 allows a Contracting State to tax gains from the alienation of property derived by an individual who was a citizen of that State at any time during the ten year period immediately preceeding the taxable year in which the property was alienated. In the case of a U.S. citizen such gains are taxable by the United States also pursuant to paragraph 3 of Article 1 (Personal Scope).

The term "gains" includes amounts taxed as capital gains and as ordinary income.

Article 14. INDEPENDENT PERSONAL SERVICES

Unlike the 1959 Convention, this Convention provides two separate Articles--Articles 14 and 15--dealing with the taxation of income from independent and dependent personal services. In addition, the rules of Articles 14 and 15 differ from rules of the 1959 Convention concerning the taxation of services income. See Article XI of the 1959 Convention.

Independent personal services are, in general terms, services performed by an individual for his own account where he receives the income and bears the losses arising from the services. Generally, services rendered by persons such as physicians, lawyers, engineers, architects, dentists and accountants as sole proprietors or partners are independent personal services, whereas services performed as an employee or as an officer of, for example, a company constitute dependent personal services.

Paragraph 1 of this Article provides that income derived by an individual who is a resident of a Contracting State from the performance of personal services in an independent capacity shall generally not be taxable in the other Contracting State. However, such income may also be taxed in the other Contracting State if such services are performed in that other State and either: the income is attributable to a fixed base in that other

State which the individual has regularly available for the purpose for performing his activities; the individual is present in that other State for 90 days or more in the taxable year; or, net income derived by the individual from residents of that other State exceeds $5,000 (or its equivalent in Jamaican dollars) during the taxable year. In the third case, if the net income exceeds $5,000, the entire amount may be taxed by the other State.

The term "fixed base" is not defined but, in general, is intended to be the same as a permanent establishment.

Article 15. DEPENDENT PERSONAL SERVICES

This Article generally provides that, subject to the provisions relating to directors' fees (Article 16), artistes and athletes (Article 18), pensions and annuities (Article 19) and government services (Article 20), remuneration derived by a resident of a Contracting State in respect of an employment may be taxed only by that State unless and to the extent that such remuneration is for employment exercised in the other Contracting State, in which case the latter State may also tax such remuneration. Even if the employment is exercised in the other Contracting State, however, such remuneration is taxable only in the person's State of residence if his net income in the taxable year from such employment in the other State is not more than $5,000 (or its equivalent in Jamaican dollars); or, he is present in the other State for not more than 183 days in the taxable year, he is paid by, or on behalf of, an employer who is not a resident of the other State, and the remuneration is not deductible in computing taxable income of a permanent establishment or fixed base of the employer in the other State.

Paragraph 3 provides a special rule for remuneration derived by members of the regular complement of ships or aircraft operated by an enterprise of a Contract State in international traffic. Such remuneration is taxable only by the Contracting State of which the enterprise operating the ship or aircraft is resident.

Article 16. DIRECTORS' FEES

This Article provides that a resident of a Contracting State who derives fees for services performed in the other Contracting State as a director of a company resident in that other State may be taxed by that State on such fees except where the amount of such fees, not including expenses reimbursed to him or borne on his behalf, does not exceed $400 (or its equivalent in Jamaican dollars) per day for each day such person is present in that other State for the purpose of performing such services. In the event that the director's fees exceed the daily allowance, the full amount of such fees is subject to tax by that other State.

Article 17. LIMITATIONS ON BENEFITS

Article 17, which is amended by the 1981 Protocol, assures that source basis tax benefits granted by a Contracting State pursuant to the Convention go to the intended beneficiaries--the residents of the other Contracting State--and not to residents of third States not having a substantial business and tax nexus with the other Contracting State. In the absence of Article 17, residents of a third State might organize a company in a Contracting State for the purpose of, for example, claiming preferential source basis tax rates in the other Contracting State.

Paragraph 1 provides that any person other than an individual (e.g., a company or a trust), which is a resident of a Contracting State shall not be entitled to relief from source basis tax under the Convention in the other Contracting State unless:

(a) more than 75 percent of the beneficial interest in such person is owned, directly or indirectly, by one or more individuals resident in the first-mentioned State; and

(b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities to persons who are residents of third States, other than any resident of a third State who is a citizen of either of the Contracting States and taxable by such State on his worldwide income on the basis of citizenship.

The term "liabilities" used in subparagraph (b) of paragraph 1 includes liabilities for items such as interest or royalties. A company that has substantial trading in its stock on a recognized exchange in either of the Contracting States is presumed, solely for purposes of subparagraph (a), to be owned by individuals resident in the Contracting State in which the company itself is resident (as determined under Article 4 (Residence)). Thus, a Jamaican company having substantial trading in its stock on a recognized exchange in Jamaica or in the United States is presumed to be owned by residents of Jamaica and, therefore, is presumed to satisfy the requirements of subparagraph (a). Paragraph 1 applies to relief from taxation that would otherwise be granted pursuant to provisions such as Article 7 (Business Profits), Article 8 (Shipping and Air Transport), Article 10 (Dividends), Article 11 (Interest), Article 12 (Royalties), and Article 13 (Capital Gains).

Paragraph 2 provides that a person who cannot, or does not, demonstrate that the requirements of paragraph 1 are met may obtain source basis tax benefits under the Convention by demonstrating that the acquisition, ownership or maintenance of such person, and the conduct of such person's operations did not have as a principal purpose obtaining such benefits under the Convention. Paragraph 3 illustrates circumstances where the requirements of paragraph 2 have been satisfied. As explained in the Exchange of Notes accompanying the Protocol, paragraph 3 is not intended to suggest that the requirements of paragraph 2 cannot be met in other circumstances, nor to limit the factors that may be taken into account in determining whether the requirements of paragraph 2 have been met.

Article 18. ARTISTES AND ATHLETES

This Article deals with the taxation of income derived by a resident of a Contracting State as a entertainer, musician or athlete from the performance of services as such in a Contracting State. Paragraph 1 overrides the provisions of Article 14 (Independent Personal Services) and Article 15 (Dependent Personal Services) to allow the other State to tax such income, where the latter Articles would not permit such taxation, but only if the gross receipts for such services, not including expenses reimbursed to the artiste or athlete or borne on his behalf, exceeds $400 (or its equivalent in Jamaican dollars) per day of performance or $5,000 (or its equivalent in Jamaican dollars) in the taxable year. If such gross receipts exceed $400 per day or $5,000 per year, the full amount, not just the excess, is subject to tax by the Contracting State in which the services are performed. Income derived from services rendered by persons such as producers, directors and technicians and others who are not artistes and athletes is taxable in accordance with the provisions of Article 14 or Article 15, as the case may be.

Paragraph 2 deals with cases in which income in respect of the activities of an entertainer or athlete accrues to a person other than, or in addition to, the entertainer or athlete; e.g., where the entertainer performs services as an employee of, or a contractor for, a corporation or other person. Paragraph 2 provides that income in respect of the personal activities of an artiste or athlete which accrues to the benefit of another person, including a company, trust, or partnership, may, notwithstanding the provisions of Articles 7 (Business Profits), 14 and 15 be taxed in the Contracting State in which the activities of the entertainer or athlete take place. Thus, such other person could not claim the permanent establishment protection otherwise provided by Article 7. For purposes of paragraph 2, income is considered not to accrue to another person if it is established that neither the artiste or athlete, nor any persons related to him, has a right to participate directly or indirectly in the profits of such other person, in any manner, including the receipt of deferred compensation, bonuses, fees, dividends, partnership distributions, or other distributions. A person may be considered related to the artiste or athlete regardless of whether the person is considered to be related to him under the provisions of paragraph 5 of Article 9 (Associated Enterprises). Paragraph 2 does not affect the rule of paragraph 1 that applies to the entertainer or athlete himself.

Article 19. PENSIONS, etc.

Article 19 provides rules concerning the taxation of pensions, social security payments, annuities, alimony, and child support. Paragraph 1 provides that, in general, pensions and other similar remuneration beneficially derived by a resident of a Contracting States in consideration of past employment shall be taxable only by that State. However, the other Contracting State may also tax such pension if the past employment to which the pension is attributable was performed in that other State while the person was a resident of that State. Social security payments and other public pensions paid by a Contracting State to a resident of the other Contracting State (or to a citizen of the United States resident in any State) are taxable only by the Contracting State making the payments. See paragraph 2 of Article 20 (Government Service) with respect to the taxation of pensions in respect of services rendered to a Contracting State.

Paragraph 2 provides that annuities beneficially derived by a resident of the Contracting State are generally taxable only in that State. If, however, an annuity was purchased in the other Contracting State while such person was a resident of that other State, the annuity may also be taxed by that other State. Paragraph 2 defines the term annuities to mean a stated sum paid periodically at stated times during life or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration, other than services rendered.

Paragraph 3 provides that alimony paid to a resident of a Contracting State by a resident of the other Contracting State is exempt from tax by that other State. The term "alimony" is defined as periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, which payments are taxable to the recipient under the laws of the State of which he is a resident. Thus, if a U.S. resident makes periodic payments pursuant to a written separation agreement to a resident of Jamaica and such amounts are taxable to the Jamaican resident under the laws of Jamaica, such alimony is exempt from U.S. tax (unless the Jamaican resident is a U.S. citizen). If the amounts are not taxable to the Jamaican recipient under the laws of Jamaica then U.S. tax may be imposed at statutory rates (i.e., currently at 30 percent of the gross amount).

Paragraph 4 provides that both Contracting States shall exempt from tax periodic payments for the support of a minor child made pursuant to a written separation agreement or decree of divorce, separate maintenance, or compulsory support, paid by a resident of one Contracting State to a resident of the other Contracting State.

Article 20. GOVERNMENT SERVICE

Paragraph 1 provides that, as a general rule, remuneration other than pensions paid by a Contracting State, or a political subdivision or local authority thereof to any individual for services rendered to that State, subdivision or authority shall be taxable only by that State. Paragraph 1 also provides, however, that such remuneration shall be taxable only by the other Contracting State if the services are rendered in that other State by an individual who is a resident and national of that other State. Thus, if a Jamaican citizen and resident is employed by the Government of the United States and is rendering services in Jamaica, only Jamaica may tax his wages.

Paragraph 2 provides that a pension paid by a Contracting State or a political subdivision or a local authority thereof to any individual as consideration for services rendered to that State or subdivision or local authority is taxable only by that State. If, however, the recipient is both a national and a resident of the other State, and was a national of that State at the time the services were rendered, then such income is taxable only by that other Contracting State.

Pursuant to paragraph 3, the provisions of Article 20 apply only to remuneration and pensions in respect of governmental services. Remuneration and pensions in respect of services performed in connection with a business carried on by a Contracting State or a political subdivision or local authority thereof are taxable under the provisions of Articles 14 (Independent Personal Services), 15 (Dependent Personal Services), 18 (Artistes and Athletes), and 19 (Pensions, etc.). Whether services are governmental or performed in connection with a business is determined under the laws of the Contracting State where the services are performed.

Pursuant to paragraph 4(b) of Article 1 (Personal Scope), the benefits of Article 20 conferred by a Contracting State are not subject to the the saving clause in paragraph 3 of Article 1, in the case of individuals who are neither citizens of nor have immigrant status in that State. In other cases, the saving clause does apply.

Article 21. STUDENTS AND TRAINEES

Paragraph 1 provides that a resident of one of the Contracting States who goes to the other Contracting State for the purpose of full-time education or training shall be exempt from tax by that other Contracting State on payments made to him from sources outside that State for the purpose of his maintenance, education or training.

Paragraph 2 provides that an individual who is a resident of a Contracting State at the time he becomes temporarily employed in the other Contracting State for the primary purpose of acquiring technical, professional or business experience from a person other than the person who employed him in the first-mentioned Contracting State, or a person related to such person, or studying at a university or other recognized educational institution shall be exempt from tax by that other Contracting State for a period not exceeding 12 consecutive months with respect to his net income from personal services in an amount not in excess of $7,500, or its equivalent in Jamaican dollars. Thus, a resident of Jamaica employed by a company resident in Jamaica, who trains for a period of 12 months at a salary of $7,500 in the United States with an unrelated company, and in order to acquire technical skills, is exempt from United States tax on such income.

Paragraph 3 provides that a student or trainee to whom paragraph 1 or 2 would otherwise apply may elect to be treated for tax purposes as a resident of the State which he is visiting for the purposes of his education or training. Under this rule, a Jamaican resident who comes to the United States as a student or trainee may elect to be taxed on his worldwide income by the United States and to claim the same deductions and personal exemptions which are available to U.S. residents. He would be considered a resident of the United States for purposes of this Convention. Such an election would benefit a student or trainee with limited income, principally from U.S. sources, especially if he is supporting dependents, since a nonresident alien is only allowed one personal exemption. The election would presumably not be made by a student or trainee with large amounts of foreign source income, because if he so elects, his foreign source income would become subject to U.S. tax. Once the election is made, it may not be revoked during the time the person qualifies for treatment under paragraph 1 or 2, except with the consent of the competent authority of the host State.

The benefits conferred by the host State under this Article are not subject to the saving clause in paragraph 3 of Article 1 (Personal Scope), with respect to individuals who are neither citizens of nor have immigrant status in that State. In other cases, the saving clause does apply.

Article 22. TEACHERS AND RESEARCHERS

The Article provides that if an individual who is a resident of one of the Contracting States visits the other Contracting State for a period not expected to exceed two years for the purpose of teaching or engaging in research at a university, college, school, or other educational institution in that other State, the remuneration paid to him in that other State for a period not exceeding two years from the date of his first visit for such purpose shall be exempt from tax by that other State. Paragraph 2 only applies to income from research if the research is undertaken by the individual in the public interest; paragraph 2 does not apply to income from research carried on primarily for the benefit of some other private person or persons. An individual shall be entitled to the benefits of paragraph 1 only once.

The benefits conferred by the host State under this Article are not subject to the saving clause in paragraph 3 of Article 1 with respect to individuals who are neither citizens of nor have immigrant status in that State. In other cases, the saving clause does apply.

Article 23. OTHER INCOME

This Article provides in paragraph 1 that, in general, any income of a resident of a Contracting State which is not dealt with in the foregoing Articles of the Convention, such as prizes and awards, shall be taxable only by that State. This rule is not confined to income from the other Contracting State, but applies, as well, to income arising in third States.

Paragraph 2 excepts from the rule of paragraph 1 income derived by a resident of a Contracting State which is attributable to a permanent establishment or fixed base of that resident in the other Contracting State. In such a case, the income is covered instead under the Articles dealing with business profits (Article 7), independent personal services (Article 14), or artistes and athletes (Article 18). Thus, for example, income of a U.S. resident from real property situated in a third State, which is attributable to a permanent establishment of such person in Jamaica would be subject to tax by Jamaica.

Paragraph 3 provides that, notwithstanding paragraphs 1 and

2, items of income of a resident of a Contracting State not dealt with in the foregoing Articles of the Convention and arising in the other Contracting State may be taxed by that other State.

Article 24. RELIEF FROM DOUBLE TAXATION

Paragraph 1 provides that the United States shall give a foreign tax credit for the appropriate amount of income taxes paid or accrued to Jamaica. Paragraph 1 provides a credit both for Jamaican taxes imposed on a recipient of income arising in Jamaica, and in the case of a U.S. company owning at least 10 percent of the voting power of a company resident in Jamaica from which the U.S. company receives dividends in the taxable year, the appropriate amount of Jamaican taxes paid or accrued by the Jamaican company with respect to the profits out of which it paid dividends. In this regard, the Jamaican taxes referred to in paragraphs 2(b) and 3 of Article 2 (Taxes Covered) are considered to be income taxes for purposes of paragraph 1, whether or not such payments are income taxes under the Code. As noted in the discussion of paragraph 3 of Article 2, however, any tax imposed by Jamaica, whether by statute or by contract, in lieu of the income tax or the company profits tax must meet the requirements of Code section 903. If Jamaica were to modify by contract a tax described in paragraphs 2(b) and 3, that contractual tax would be creditable for U.S. purposes if it met the requirements of Code section 901 or 903. Further, whether Jamaican taxes are paid or accrued is determined under the rules of the Code.

The amount of credit granted under the Convention for Jamaican taxes is subject to the limitations provided by United States law for the taxable year for the purposes of limiting the credit to the U.S. tax on income from sources outside of the United States. Paragraph 3, which identifies the source of income and profits for the purposes of Article 24, provides the source rules necessary to compute the foreign tax credit under the Convention. A taxpayer may, for any year, claim a foreign tax credit under the rules of the Code. Thus, he would forego the rules of the Convention that guarantee income tax status for the specified Jamaican taxes.

The source rules of paragraph 3 provide that the source of:

(a) dividends described in Article 10, is in the State of residence of the paying comapny;

(b) interest, as defined in Article 11 (Interest), is in the State specified in paragraph 6 of Article 11;

(c) royalties, as defined in paragraph 3 of Article 12 (Royalties), is in the State specified in paragraph 6 of Article 12; and

(d) except for the just-mentioned dividends, interest and royalties, dividends and interest derived from a dual resident company described in paragraph 3 of Article 4 (Residence), and income described in paragraph 3 of Article 23 (Other Income), income or profits derived by a resident of a Contracting State which may be taxed by the other Contracting State (other than solely by reason of citizenship) are deemed to arise in that other State.

Paragraph 2 provides that, subject to the provisions and limitations of Jamaican law regarding the allowance of foreign tax credits, Jamaica will allow to a resident of Jamaica as a credit against Jamaican tax on income the appropriate amount of income tax paid or accrued to the United States. In the case of dividends from a United States company to a Jamaican comapny which owns at least 10 percent of the voting power of the U.S. company, Jamaica will also allow a credit for the appropriate amount of United States tax imposed with respect to the profits out of which dividends are paid. The U.S. taxes referred to in paragraph 2(a) and 3 of Article 2 are considered to be income taxes for purposes of applying the Jamaican credit in relation to U.S. taxes.

The saving clause in paragraph 3 of Article 1 (Personal Scope) does not apply to this Article. Thus, the provisions of this Article may be relied upon by a citizen or resident of a Contracting State.

Article 25. NON-DISCRIMINATION

Paragraph 1 provides that nationals of a Contracting State (e.g., individuals and companies) shall not be treated less favorably with respect to taxation and connected requirements by the other Contracting State than are nationals of that other Contracting State in the same circumstances. Nationals who are subject to tax on their worldwide income by a Contracting State are not in the same circumstances as nationals of another State who are not taxed on their worldwide income by the first-mentioned State. Thus, the United States is not obligated to treat a national of Jamaica who is a resident of a third State in the same manner as a United States national who is a resident of that third State.

Paragraph 2 provides that a Contracting State may not impose more burdensome taxes on a permanent establishment in that State of an enterprise of the other Contracting State than the first-mentioned State imposes on its own enterprises carrying on the same activities.

Paragraph 3 prohibits discrimination in the matter of deductions. Interest, royalties, and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State must be deductible disbursements for determining taxable profits in the first-mentioned State under the same conditions as if they had been paid to a resident of the first-mentioned State. Exceptions to this rule arise where the provisions of paragraph 1 of Article 9 (Associated Enterprise) paragraph 7 of Article 11 (Interest) or paragraph 5 of Article 12 (Royalties) apply. The term "other disbursements" includes a reasonable allocation of executive and general administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related enterprises.

Paragraph 4 requires that a Contracting State not impose more burdensome taxation on an enterprise of that State owned by residents of the other Contracting State than the first-mentioned State imposes on other similar enterprises of that State.

Paragraph 5 repeats the statement of paragraph 4 of Article 2 (Taxes Covered) that Article 25 applies to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority.

Paragraph 6 provides two exceptions to coverage of this Article. Subparagraph (a) clarifies that a Contracting State is not obligated to grant to individuals not resident in that State personal allowances, reliefs or credits for taxation that it grants individuals who are so resident. Subparagraph (b) allows Jamaica to charge a higher rate of income tax under section 48(5) of the Income Tax Act of Jamaiaca on life insurance companies which are residents of the United States than on a regionalized life assurance company.

Paragraph 7, added by the July 17, 1981 Protocol, allows U.S. income tax deductions for certain convention expenses that, absent paragraph 7, would not be deductible in computing U.S. tax liability because of Code section 274(h). Paragraph 7 provides that specified expenses incurred by a U.S. citizen or resident in connection with attendance at a convention, seminar or similar meeting held in Jamaica shall be deductible for U.S. tax purposes to the same extent as if the meeting were held in the United States. Paragraph 7 allows deductions only for ordinary and necessary business expenses for: lodging, meals and the personal sustenance and comfort of the traveler while at the convention in Jamaica; registration at the convention and books and other similar materials necessary for attendance at the convention; ground and air transportation to and from the convention site, but not in excess of the amount deductible under the Code with respect to transportation expenses incurred in connection with travel outside the United States. Thus, the deductibility of transportation expenses is subject to the rules of Code section 274(c). A U.S. taxpayer can claim benefits under section 274(h) with respect to a convention held in Jamaica and meeting the requirements of that section or, in the alternative, he can choose to rely on the provisions of paragraph 7 with respect to the expenses attributable to the convention if the provisions of paragraph 7 prove more beneficial.

The provisions of this Article do not override the right of the United States to impose the tax provided in Code section 897 (relating to gains derived by nonresident aliens or foreign corporations from U.S. real property interests).

The saving clause in paragraph 2 of Article 1 (Personal Scope) does not apply to Article 25.

Article 26. MUTUAL AGREEMENT PROCEDURE

Paragraph 1 provides that a person who considers that the actions of one or both of the Contracting States result, or will result, for him in taxation not in accordance with the Convention, he may present his case to the competent authority of the State of which the person is a resident or national. The person need not first have exhausted the remedies available to him in the domestic laws of the Contracting States. Paragraph 1 specifies that a resident of a Contracting State who has a permanent establishment or a fixed base in the other Contracting State may present his case to the competent authority of either Contracting State.

Paragraph 2 provides that the competent authority, if it considers the objection to be justified, and if it is not able to arrive at a satisfactory solution itself, shall endeavor to resolve the case by mutual agreement with the competent authority of the other Contracting State in order to avoid taxation not in accordance with the Convention. Any agreement so reached shall be implemented without regard to any statutory time limits of the Contracting States. In the case of Jamaica, however, the taxpayer or the U.S. competent authority must give notice to the Jamaican competent authority of the possible claim for tax adjustment within the statutory time limits of Jamaica. Thus, if a taxpayer notifies the competent authority of Jamaica of a possible claim for an adjustment of Jamaican tax within the time provided in Jamaica's statute of limitations, then the taxpayer may file its formal claim for refund from Jamaica after the expiration of the Jamaican statute of limitations and still have such claim considered by Jamaica. Paragraph 2 does not, however, obligate the U.S. competent authority to reduce or waive a proposed U.S. tax adjustment, such as an adjustment concerning associated enterprises, if timely notice is not given to the

Jamaican competent authority of a possible corresponding adjustment of Jamaican tax.

Paragraph 3 provides that the competent authorities shall endeavor by mutual agreement to resolve any difficulties or doubts which may arise as to the interpretation or application of the Convention. They may also consult together to eliminate double taxation in cases not specifically provided for in the Convention. The competent authorities may, for example, agree to:

(a) the attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment in the other Contracting State;

(b) the allocation of income, deductions, credits, or allowances between persons;

(c) the characterization of items of income;

(d) the application of source rules; and

(e) the meaning of a term.

Thus, the competent authorities may agree to a common method of treating an issue in the interest of avoiding double taxation by the two Contracting States.

Paragraph 4 provides that the competent authorities may communicate with each other directly for the purpose of reaching agreement in accordance with Article 26.

Paragraph 5 provides that the competent authorities may agree to increase any dollar amounts specified in the Convention. Such increases would be made to reflect monetary or economic developments. Thus, if the competent authorities agree that due to inflation in the two Contracting States the $5,000 threshold for the taxation of service income provided in paragraph 1(c) of Article 14 (Independent Personal Services) is no longer adequate given the purposes of Article 14, they may agree to a higher amount.

Article 27. EXCHANGE OF INFORMATION

Paragraph 1 provides that the competent authorities shall exchange such information as is necessary for carrying out the provisions of the Convention or of their domestic laws concerning taxes covered by the Convention. Paragraph 1 clarifies that the competent authorities may also exchange such information as is necessary to prevent fraud or tax evasion in respect of taxes covered by the Convention. Paragraph 1 requires that information so exchanged will be protected in the same manner as information obtained under domestic laws with respect to secrecy and disclosure. The use of such information is limited to those persons involved in the assessment, collection and enforcement of taxes covered in the Convention. Information may be exchanged pursuant to paragraph 1 with respect to persons who are not residents of either Contracting State.

The provisions of paragraph 1 are intended to authorize the U.S. competent authority to allow the General Accounting Office access to tax return information received from Jamaica when GAO is engaged in a study of the administration of U.S. tax laws pursuant to a directive of Congress. The secrecy requirements of paragraph 1 must, however, be met.

Paragraph 2 provides that the State to which a request has been made shall provide information in specified forms to be admissible in judicial proceedings of the requesting State. The specified forms include authenticated copies of unedited original documents, but only to the extent that such forms of information can be obtained under the laws and practices of the State with respect to its own taxes.

Paragraph 3 explains that paragraphs 1 and 2 do not obligate the United States or Jamaica to carry out measures contrary to the laws and administrative practice of either State; to supply information not obtainable under the laws or in the normal course of the administration of either State; or to supply information which would disclose trade secrets or other information the disclosure of which would be contrary to public policy. Thus, Article 27 allows, but does not obligate, the United States and Jamaica to obtain and provide information the disclosure of which would not be available to the requesting State under its laws or administrative practice or that in different circumstances would not be available to the State requested to provide information. Further, Article 27 authorizes a Contracting State to obtain information for the other Contracting State even if there is no tax liability in the State requested to obtain the information.

Paragraphs 4 and 5 provide for assistance in collection of taxes, within the parameters of a Contracting State's domestic tax laws, sovereignty, security and public policy, to ensure that Convention benefits do not accrue to persons not entitled thereto.

Paragraph 6 provides that the competent authorities may exchange information concerning every tax imposed by a Contracting State, not just the taxes listed in paragraph 2 of Article 2 (Taxes Covered)

Article 28. DIPLOMATIC AGENTS AND CONSULAR OFFICERS

This Article provides that this Convention shall not affect taxation privileges of diplomatic or consular officials under the rules of special agreements or international law.

Article 29. ENTRY INTO FORCE

Paragraph 1 provides that the Convention be ratified by the Contracting States in accordance with their applicable procedures and that the instruments of ratification be exchanged at Washington as soon as possible.

Paragraph 2 provides that the Convention will enter into force upon the exchange of instruments of ratification. Once the Convention enters into force it shall have effect:

(a) in respect of tax withheld at the source, to amounts paid or credited on or after the first day of the second month next following the date on which the Convention enters into force;

(b) in respect to other taxes, to taxable periods beginning on or after the first day of January next following the date on which the Convention enters into force.

Paragraph 3 provides for the termination of the 1959 Convention. The 1959 Convention shall cease to have effect with respect to the United States and Jamaica from the date on which the corresponding provisions of this Convention have effect according to paragraph 2.

Article 30. TERMINATION

The Convention shall remain in force unless terminated by one of the Contracting States. Either Contracting State may terminate the Convention at any time after five years from the date on which it enters into force by giving at least six months' prior notice through diplomatic channels. In that event, the Convention shall cease to have effect:

(a) in respect of tax withheld at the source, to amounts paid or credited on or after the first of January following the expiration of the six months' period of notice (i.e., if notice is given by June 30 of one year, the termination will be effective on January 1 of the following year);

(b) in respect of other taxes, to taxable periods beginning on or after the first day of January next following the expiration of the six months' period.

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TECHNICAL EXPLANATION OF THE AGREEMENT BETWEEN THE UNITED STATES OF AMERICA AND THE REPUBLIC OF MALTA WITH RESPECT TO TAXES ON INCOME SIGNED AT VALLETTA ON MARCH 21, 1980

INTRODUCTION

This Agreement is designed to avoid double taxation and prevent fiscal evasion with respect to taxes on income. It was negotiated on the basis of the U.S. Model Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital published on May 17, 1977, (hereafter referred to as the "U.S. Model"). In general, the U.S. Model reflects the revised Model Double Taxation Convention on Income and on Capital published by the Organization for Economic Cooperation and Development (OECD) in 1977, (hereafter referred to as the "OECD Model"). The Agreement incorporates a number of modifications to the U.S. Model, designed principally to reflect Malta's status as a developing country. The term "Agreement" as used throughout the document does not differ in substance from the normally used term "Convention."

The technical explanation is an official guide to the Agreement. It reflects policies behind particular Agreement provisions, as well as understandings reached with respect to the interpretation and application of the Agreement.

Article 1. PERSONAL SCOPE

This Article identifies the persons who come within the scope of the Agreement (hereafter referred to as "the Treaty").

Paragraph (1) is taken directly from the U.S. Model and provides that, except as otherwise provided, the Treaty applies to residents of one or both of the Contracting States. The term "resident" is defined in Article 4 (Fiscal Residence). The exception refers to certain cases in which the Treaty may also apply to residents of third countries because of their relationship to a resident of a Contracting State or because they are citizens of a Contracting State. For example, under paragraph (5) of Article 10 (Dividends), the Treaty covers certain dividends derived by residents of third countries. Similarly, Article 27 (Exchange of Information) may apply to residents of third countries.

Paragraph (2) provides that the Treaty shall not restrict any benefit provided by the laws of either Contracting State or by any other agreement between the Contracting States. Thus, if a deduction would be allowed in computing the taxable income of a Malta resident under the Internal Revenue Code of 1954 ("Code"), such a deduction is generally available to him in computing taxable income under the Treaty. A taxpayer, however, may not make inconsistent choices between Code and Treaty rules. For example, if a resident of Malta claims the benefits of the "attributable to" rule of paragraph (1) of Article 7 (Business Profits) with respect to the taxation of business profits of a permanent establishment, he must use the "attributable to" concept consistently for all items of income and deductions and may not rely upon the "effectively connected" rules of the Code with respect to other items of income otherwise attributable to a permanent establishment. In no event, however, are the rules of the Treaty to increase overall U.S. tax liability from what it would be if there were no treaty. It follows that a right to tax under the Treaty cannot be exercized unless that right also exists under the Code.

Paragraph (3) contains the traditional "saving clause" under which each Contracting State reserves the right to tax its residents, as determined under Article 4 (Fiscal Residence), and its citizens as if the Treaty had not come into effect.

Paragraph (4) sets forth certain exceptions to the application of the saving clause where other provisions of the Treaty reflect overriding policies, and without these exceptions, the provisions would not serve their intended purpose. For example, under paragraph (4)(a), the saving clause does not affect the benefits provided under Article 24 (Relief From Double Taxation), Article 25 (Non-Discrimination), and Article 26 (Mutual Agreement Procedure) which are available, notwithstanding the saving clause, to residents and citizens of the Contracting States.

In a second category of exceptions, the saving clause will not override benefits conferred by a Contracting State upon residents who are not citizens of, and do not have immigrant status in, that State. "Immigrant status," in the United States, refers to the possession of a "green card." For tax purposes, the possession of a green card is not necessary for acquiring residence status. This second category of exceptions includes benefits conferred under Article 20 (Government Service), Article 21 (Teachers), Article 22 (Students and Trainees), and Article 28 (Diplomatic Agents and Consular Officers).

This paragraph differs from paragraph (4) of Article 1 of the U.S. Model only in omitting cross references to social security benefits and child support payments under subparagraph (a) and in adding a cross reference to teachers under subparagraph (b).

Article 2. TAXES COVERED

Paragraph (1) states the general rule that the Treaty applies to income taxes imposed on behalf of a Contracting State. Paragraph (1) is not intended either to broaden or limit the scope of paragraph (2). Capital taxes, though covered in the U.S. Model, were omitted from the Treaty.

Paragraph (2) designates the existing taxes to which the Treaty shall apply. In the case of the United States, these are the Federal income taxes imposed by the Code, the excise tax on insurance premiums paid to foreign insurers (Code section 4371), and the excise taxes with respect to private foundations (Code sections 4940 and 4948). (See paragraph (6) of Article 7 and the explanation thereto for the effect of covering the insurance premium excise in the Treaty.)

United States taxes not generally covered by the treaty include the estate, gift, and generation skipping transfer taxes, the Windfall Profits Tax, Federal unemployment taxes, and social security taxes imposed under sections 1401, 3101 and 3111 of the Code.

In the case of Malta, the covered tax is the income tax, which is defined to include prepayments of the tax, whether made by deduction at the source or otherwise. Under paragraph (1) of Article 24 (Relief From Double Taxation), the United States agrees that the Malta taxes enumerated in paragraph (2)(b) and those which may be covered under paragraph (3) of this Article are income taxes for purposes of the U.S. foreign tax credit.

Paragraph (3) provides that the Treaty shall also apply to any taxes imposed subsequent to the date of signature which are substantially similar to the then existing taxes covered by the Treaty. The competent authorities agree to notify each other of any significant changes in their respective tax laws and of any official published material relating to the application of the Treaty. This provision is substantially the same as paragraph (3) of the U.S. Model.

Paragraph (4) preserves for the United States the right to impose its personal holding company tax under section 541 of the Code and its accumulated earnings tax under section 531 of the Code notwithstanding any provision of the Treaty. However, paragraph (4) also provides that a Malta company will be exempt from the personal holding company tax in any taxable year unless one or more United States residents or citizens own, directly or indirectly, within the meaning of section 544 of the Code, ten percent or more in value of the outstanding stock of the company.

In addition, a Malta company will be exempt from the accumulated earnings tax in any taxable year unless at least 25 percent of the voting stock of such company is owned by United States citizens or residents.

Paragraph (5) provides that for the purposes of Article 25 (Non-Discrimination), the Treaty applies to taxes of all kinds imposed at all levels of government. This provision corresponds to that found in the U.S. Model. The U.S. Model also extends the taxes covered, for purposes of exchanges of information, to all taxes imposed by a Contracting State. The Treaty does not include such an extension of the coverage because Malta has no authority to exchange information under an income tax treaty with respect to taxes other than income taxes.

Article 3. GENERAL DEFINITIONS

Paragraph (1), like paragraph (1) of the U.S. Model, defines the principal terms used throughout the Treaty. Unless the context otherwise requires, the terms defined in this paragraph have a uniform meaning throughout the Treaty. A number of important terms, however, are defined in other articles. For example, the terms "resident" and "permanent establishment" are defined in Articles 4 (Fiscal Residence) and 5 (Permanent Establishment), respectively, and the terms "dividends," "interest," and "royalties" are defined in Articles 10 (Dividends), 11 (Interest), and 12 (Royalties).

The term "person" is defined to include an individual, a partnership, a company, an estate, a trust and any other body of persons.

The term "company" means any body corporate or any other entity which is treated as a body corporate for tax purposes.

The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean an enterprise carried on by a resident (as defined by Article 4) of the United States or Malta, as the context requires.

The term "international traffic" means any transport by a ship or aircraft except where such transport is solely between places in the other Contracting State. Thus, coastal shipping along the Atlantic coast of the United States is not international traffic. However, if a ship operated by a resident of Malta transports goods from Canada to the United States, leaving some of the goods in New York and the remainder in Norfolk, the entire transport would be international traffic. The definition is relevant principally for purposes of Article 8 (Shipping and Air Transport).

A "national" of the United States is defined as a citizen of the United States as well as all legal persons, partnerships, and associations deriving their status as such from the laws in force in the United States. A "national" of Malta is defined as a citizen of Malta, as provided for in the Constitution of Malta and in the Maltese Citizenship Act of 1965, and any legal person, partnership, or association deriving its status as such from the law in force in Malta.

In the U.S. Model, a "national" is defined in Article 24 (Non-Discrimination). However, since the term is used in other Articles as well (e.g., Article 20 (Government Service) and Article 26 (Mutual Agreement Procedure)), the definition is included here among the general definitions in Article 3. The U.S. Model defines a national of the United States as a citizen. The addition to the definition of legal persons, partnerships, and associations is taken from the OECD Model. The effect of this expanded definition is to broaden the scope of paragraph (1) of Article 25 (Non-Discrimination) which assures that nationals of one Contracting State will be subject to no less favorable treatment in the other Contracting State than the latter accords its own nationals.

With respect to the United States, the term "competent authority" means the Secretary of the Treasury or his delegate. With respect to Malta, the term means the Minister responsible for finance or his authorized representative.

The term "United States" is defined to mean the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam, or any other U.S. possession or territory. The United States, when used in a geographical sense, is further defined to include its territorial sea and continental shelf, the latter only to the extent of property or activities connected with the exploration for or exploitation of the natural resources of the shelf. Although the U.S. Model does not explicitly include the continental shelf in the definition of the United States, by virtue of section 638 of the Code it is considered to be covered in the U.S. Model in the same way as in the Treaty.

The term "Malta" means the Republic of Malta and, when used in a geographical sense, it means the Maltese islands and includes the territorial sea and continental shelf (limited in the same way as in the case of the United States).

The terms "a Contracting State" and "the other Contracting

State" mean the United States or Malta, as the context requires.

Paragraph 2 is from the U.S. Model. It provides that, in the case of a term not defined in the Treaty, the domestic tax law of the Contracting State applying to the Treaty shall control, unless the context in which the term is used requires a definition independent of domestic tax law or the competent authorities reach agreement on a meaning pursuant to Article 26 (Mutual Agreement Procedure). The term "context" refers to the purpose and background of the provision in which the term appears.

Pursuant to the provisions of Article 26, the competent authorities of the Contracting States may resolve any difficulties or doubts as to the interpretation or application of the Treaty. An agreement by the competent authorities with respect to the meaning of a term used in the Treaty would supersede conflicting meanings in the domestic laws of the Contracting States.

Article 4. FISCAL RESIDENCE

Article 4 provides a detailed definition of the term "resident of a Contracting State." The definition begins with a person's liability to tax as a resident under the respective taxation laws of the Contracting States. A person who, under those laws, is a resident of one Contracting State and not the other need look no further. However, the Treaty definition is also designed to assign residence to one State or the other for purposes of the Treaty in circumstances where each of the Contracting States believes a person to be its resident. The Treaty definition is, of course, exclusively for purposes of the Treaty.

Paragraphs (1) through (6) of this Article correspond to paragraphs (1) through (6) of Article 4 (Resident) of the U.S. Model, with minor changes in paragraphs (1)(a) and (6).

Paragraph (1) lists a number of criteria which may be used under the laws of a Contracting State to determine residence, such as domicile, residence, citizenship, place of management, or place of incorporation. Included as a resident of the United States would be a resident alien individual who is subject to tax by the United States on his worlwide income, or an alien present in the United States who elects to be so treated under Code section 6013(g) or (h), as well as a resident U.S. citizen. A U.S. citizen living in a third country would be treated as a resident of the United States for purposes of this treaty. A person liable to tax in a Contracting State only on income from sources in that State is not considered to be a resident of that State for purposes of the Treaty.

Since the Treaty does not cover taxes on capital, the references to capital contained in the U.S. Model have been omitted from this paragraph.

When applied with respect to income derived by a partnership, estate, or trust, the term "resident" applies only to the extent that income derived by such partnership, estate, or trust is subject to tax as the income of a resident of a Contracting State either in its hands or in the hands of the partners or beneficiaries. For example, if a Malta partnership, which is comprised of one partner resident in Malta and another partner resident in a third country, derives dividends from the United States, the limitation of U.S. tax under the provisions of Article 10 (Dividends) of the Treaty applies only to the portion of the dividend attributable to the partner who is a resident of Malta.

Paragraph (2) provides a series of tie-breaking rules for assigning a residence to an individual who, under paragraph (1), would be a resident of both countries. The first test is where the individual has a permanent home. If this test is inconclusive because the individual has a permanent home in both countries or in neither of them, his residence is in the State where his center of vital interests lies, i.e., the State with which his personal and economic relations are closer. If such a center cannot be determined, residence is where the individual has an habitual abode. If he has an habitual abode in both countries or in neither of them, he is deemed to be a resident of the State of which he is a national. Should the individual be a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question of residence by mutual agreement.

Paragraph (3) provides that a company which, under paragraph (1), is a resident of both Contracting States because it is incorporated in the United States and has its place of effective management in Malta, shall be considered a resident only of the Contracting State under the laws of which it is created or organized. Thus, a corporation incorporated under the laws of a state of the United States is a resident only of the United States for purposes of the Treaty, while a corporation which is incorporated in Malta or which has its place of effective management in Malta (and is not incorporated in the United States) may be a resident of Malta.

Paragraph (4) provides that if, under paragraph (1), a person other than an individual or a company is a resident of both Contracting States, the competent authorities shall attempt to agree on a single residence for such person. This provision applies to persons such as trusts and estates.

Paragraph (5) provides that an individual national of one of the Contracting States shall also be considered to be a resident of that State if that individual is employed by that Contracting State or an instrumentality thereof and is engaged in the performance of governmental functions for the employing State and remains subject to income tax by the employing State as if he continued to be a resident thereof. This provision also applies to the spouse and minor children residing with such an employee if they are also subject to income tax by the employing State. This paragraph, while not found in the OECD Model, is in the U.S. Model. Under its terms, a U.S. diplomat or other employee of the United States Government performing governmental functions outside of the United States is considered to be a resident of the United States for purposes of the Treaty and is therefore entitled to the benefits provided in the Treaty for residents of the United States, such as the reduced rate of Malta tax at source with respect to interest and royalties. Conversely, a Malta diplomat stationed in the United States is a resident of Malta for purposes of the Treaty.

Paragraph (6) provides a special rule for cases where income dealt with by the Treaty (e.g., under Articles 7 (Business Profits), 8 (Shipping and Air Transport), 10 (Dividends), 11 (Interest), 12 (Royalties), and 23 (Other Income)), is taxable to a resident of a Contracting State only if, and to the extent, it is remitted to or received by that person. In certain cases, individuals who are residents of Malta are not taxable on foreign source investment income, unless it is remitted to or received by them in Malta. If such income is received outside of Malta, or accumulated by the payer, a Malta resident may not be subject to tax on that income. If the reductions in rates or exemptions from tax were to apply to those items of income, the United States would be foregoing tax where double taxation does not in fact occur. Thus, this paragraph provides that if under the law in the Contracting State of residence income would only be taxed on a remittance basis, then any reduced rates of tax (e.g., as provided by Article 10 (Dividends)), or relief from taxation (e.g., Articles 7 (Business Profits) and 8 (Shipping and Air Transport)) provided by the Treaty in the Contracting State of source shall apply only to the extent such income is remitted to or received by the person in the year in which it accrues to his benefit or during the following year. This provision differs from the comparable provision in the U.S. Model by extending the benefits of the Treaty to income which is remitted in the year following the year in which it accrues. In the Model the income must be remitted in the year of accrual to receive treaty benefits.

Article 5. PERMANENT ESTABLISHMENT

This Article defines the term "permanent establishment," which is relevant particularly to the taxation of business profits under Article 7 (Business Profits). With a few exceptions, this Article is the same as Article 5 (Permanent Establishment) of the U.S. Model.

Paragraph (1), as in the U.S. Model, defines the term "permanent establishment" as a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Paragraph (2) provides an illustrative list of fixed places of business which constitute a permanent establishment. The list includes a place of management, a branch, an office, a factory, a workshop, and a mine, an oil or gas well, or any other place of extraction of natural resources. The term "place of management" was inserted in paragraph (2) at the request of the Malta delegation to provide greater uniformity with the OECD Model. Since a place of management would in most cases require an office, which is specifically listed in paragraph (2), the addition of the term will not generally cause a fixed place of business to a be a permanent establishment if it would not otherwise be one.

As in the U.S. Model, paragraph (3) provides that a building site or construction or installation project or a drilling rig or ship used in the exploration for or development of natural resources constitutes a permanent establishment if a time threshold is met. Unlike the U.S. Model, however, the Treaty adds to the activities which may constitute a permanent establishment supervisory activities connected with any of the above. Furthermore, the Treaty shortens the time threshold from 24 months in the U.S. Model to 183 days in a 12-month period, provided that for a permanent establishment to exist in any taxable year, the site, project, or activity must continue for at least 30 days in that year. This broadening of the definition of a permanent establishment is typical of the modifications to the U.S. Model found in treaties with developing countries.

Under the building site or construction or installation project rule, the 183 day period begins when work physically commences within the territory of the Contracting State. A series of contracts or projects which are interdependent both commercially and geographically are to be treated as a single project for the purpose of applying the 183 day test. If the 183 day test is exceeded, the site or project constitutes a permanent establishment from the first day.

Paragraph (4) lists a number of exceptions to the general rule that a fixed place of business through which the activities of an enterprise are carried on constitutes a "permanent establishment." These exceptions, which do not constitute a permanent establishment, are as follows:

"(a) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise;

"(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

"(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

"(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

"(e) the maintenance of a fixed place of business solely for the purpose of advertising, for scientific research or for carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

"(f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs (a) to (e) of this paragraph."

Paragraph (4) is essentially the same as paragraph (4) of Article 5 of the U.S. Model. The only difference between paragraph (4) of the Treaty and the U.S. Model is the elaboration in subparagraph (e) of the Treaty of the kinds of activities which may be considered preparatory or auxiliary.

Paragraphs (5) and (6) apply to the use of agents. Under paragraph (5) a dependent agent acting on behalf of an enterprise who habitually exercises an authority to conclude contracts in the name of the enterprise is deemed to constitute a permanent establishment of that enterprise except to the extent that his activities are limited to those mentioned in paragraph (4), which would not constitute a permanent establishment when carried on at a fixed place of business. Paragraph (6) provides that if an enterprise of one Contracting State makes use in the other Contracting State of a broker or other agent of independent status acting in the ordinary course of business, it will not thereby be considered to have a permanent establishment in that other State.

Paragraph (7) provides that the fact that a company which is a resident of one Contracting State either controls or is controlled by a company which is a resident of the other Contracting State is not in itself relevant in determining whether a company has a permanent establishment in the other Contracting State. What is relevant is whether one company carries on for the other an activity which, within the provisions of the Article, would make the first company a dependent agent of the other. It follows that the same rules apply to two or more subsidiaries of the same company.

Article 6. INCOME FROM IMMOVABLE PROPERTY (REAL PROPERTY)

Paragraph (1) of this Article provides that income from real property may be taxed by the Contracting State in which the property is situated. This right, however, is not exclusive; the rule simply confirms that the source State has the primary right to tax such income regardless of whether the income is derived through a permanent establishment in that State.

Paragraph (2) defines real property as having the meaning it has under the laws of the Contracting State in which the property in question is situated. It goes on to specify certain types of property which, regardless of the internal law definitions, are to be included in the Treaty definition of real property. With one exception, paragraphs (1) and (2) are identical to the same paragraphs of Article 6 of the U.S. Model. The exception is the deletion of agricultural property, including livestock and equipment used in agriculture or forestry, from the definition of "immovable property." This deletion was at Malta's request and reflects the view held by Malta that the income from such property is business income, subject to Article 7 (Business Profits).

Paragraph (3), which is identical to paragraph 3 in the U.S. Model, provides that the basic rule in paragraph (1) applies to income derived from the direct use, letting, or any other use of immovable property.

Paragraph (4), which is identical to paragraph 4 of the U.S. Model, provides that the rules of this Article apply to the income from immovable property of an enterprise or from property used for the performance of independent personal services.

Paragraph (5) of the U.S. Model, providing for a binding election to be taxed on a net basis, was deleted, since such an election is available under U.S. law, and Malta taxes income from real property on a net basis.

Article 7. BUSINESS PROFITS

This Article provides rules for the taxation by a Contracting State of income from business activity carried on in that State by a resident of the other State. Throughout the Article, the term "profits" is used, as in the OECD Model, rather than the term "business profits," as in the U.S. Model. No substantive difference is intended.

Paragraph (1) provides that the profits (as defined in paragraph (8)) of an enterprise of one Contracting State shall be taxable only in that State except to the extent that such profits are attributable to a permanent establishment through which the enterprise carries on business in the other Contracting State. The term "permanent establishment" is defined in Article 5 (Permanent Establishment). This rule is found in both the U.S. Model and the OECD Model.

Paragraph (2), also taken from the U.S. Model, provides that the profits to be attributed to a permanent establishment are those which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions. The profits so attributed may be from sources within or without a Contracting State. Thus, items of income described in section 864(c)(4)(B) of the Code which are attributable to a permanent establishment in the United States may be subject to tax by the United States. In addition, the limited "force of attraction" rule in Code section 864(c)(3) does not apply for U.S. tax purposes under the Treaty.

Paragraph (3) provides that there shall be allowed as deductions those expenses incurred for the purposes of the permanent establishment, whether incurred in the State where the permanent establishment is located or elsewhere. The deductible expenses include a reasonable allocation of administrative expenses. Research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole or the part thereof which include the permanent establishment are also dealt with specifically in the U.S. Model, but are not, at Malta's request, specified in the Treaty. The United States, however, would consider these items of expense to be included in the general language of paragraph (3).

Paragraph (4) is the same as paragraph 4 of Article 7 of the U.S. Model. It provides that the mere purchase by a permanent establishment of goods or merchandise for the enterprise shall not result in profits being attributed to the permanent establishment.

Paragraph (5), which repeats paragraph 5 of the U.S. Model, provides that the same method for determining profits attributable to a permanent establishment shall be used each year unless there is good and sufficient reason to change. This assures continuous and consistent tax treatment.

Paragraph (6), which does not appear in the U.S. Model, was inserted at the request of Malta. It provides that nothing in this Article affects the application of the statutory provisions of a Contracting State to the income of an insurance business. Malta taxes foreign insurance companies, by treating as income for Malta tax purposes, that portion of worldwide profits which premiums paid in Malta bear to worldwide premiums. This tax applies whether or not the foreign insurer has a permanent establishment in Malta. Malta was not willing to waive this tax in cases where a permanent establishment is lacking. This paragraph has the effect of preserving the applicability of the U.S. excise tax on insurance premiums paid to foreign insurers (Code section 4371), which is a covered tax under paragraph (2)(a) of Article 2 (Taxes Covered), to U.S. premiums paid to Malta insurance companies which are not attributable to a permanent establishment in the United States, and Malta is obligated to grant a credit for this tax. The U.S. excise tax does not apply to premiums paid to foreign insurers which are attributable to a U.S. permanent establishment. (See Revenue Ruling 80-225).

Paragraph (7), which is the same as paragraph 6 of the U.S. Model, provides that where business profits include items of income dealt with separately in other articles of the Treaty, then the provisions of those separate articles override the provisions of this Article. Thus, the taxation of income of shipping and aircraft companies dealt with in Article 8 (Shipping and Air Transport) is governed by that Article and not by this Article. Similarly the taxation of dividends, interest, and royalties is controlled by Articles 10 (Dividends), 11 (Interest), and 12 (Royalties); however, the terms of those

Articles provide that where dividends, interest, or royalties derived by a resident of a Contracting State are effectively connected with a permanent establishment of that resident in the other Contracting State, then the provisions of this Article shall apply.

Paragraph (8) provides a definition of "profits." The term is defined to mean income derived from any trade or business carried on by any person or group of persons. The primary purpose of that definition in the U.S. Model is to make clear that film rentals and rentals of tangible personal property are profits, and therefore subject to the provisions of Article 7, with the result that such income derived by a resident of one Contracting State may not be taxed by the other Contracting State except to the extent attributable to a permanent establishment in the latter State. Malta objected to defining film rentals as profits. Such income is included in the definition of royalties in the Treaty and thus is subject to the provisions of Article 12 (Royalties). Under this treatment, the source State may tax such payments, as limited by Article 12, whether or not the recipient has a permanent establishment in that State. With this exception, the general U.S. Model definition of business profits is retained in paragraph (8), including specifically the reference to income from the rental of tangible personal (movable) property.

Unlike the U.S. Model, however, this definition is included only for purposes of Article 7, not for purposes of the entire Treaty. Where rental payments vary with the volume of sales or a similar variable, Malta expressed the view that such income might be treated as royalties rather than business profits. The limitation of the applicability of the definition of profits to Article 7 would permit Malta to characterize some of these rental payments as royalties. Because Malta taxes royalties on a net basis, even though the expenses allowed in the case of royalties is somewhat narrower than in the case of business profits, this characterization would generally have little consequence for a U.S. taxpayer with a permanent establishment in Malta. The competent authorities may be called upon to resolve any conflict that may arise in the characterization of such income in a particular case.

Article 8. SHIPPING AND AIR TRANSPORT

Paragraph (1) provides that profits of an enterprise of one of the Contracting States from operating ships or aircraft in international traffic shall be taxable only in that Contracting State. International traffic is defined in paragraph (1)(d) of Article 3 (General Definitions).

By virtue of paragraph (7) of Article 7 (Business Profits), profits of a resident of one Contracting State that are exempt under paragraph (1) from tax in the other Contracting State remain exempt even if the resident has a permanent establishment in that other State.

This provision is subject to the saving clause of paragraph (3) of Article (1) (Personal Scope). Thus, the United States may tax income from international traffic derived by a resident of Malta without regard to this Article if such resident is a citizen of the United States.

Paragraphs (2) and (3) clarify what income is to be considered profits from the operation of ships or aircraft. Paragraph (2) states that income from the operation of ships or aircraft in international traffic includes profits from the rental on a full or bareboat basis of ships or aircraft if operated in international traffic by the lessee or if such rental profits are incidental to other profits described in paragraph (1).

Paragraph (3) states that profits of an enterprise of a Contracting State from the use, maintenance, or rental of containers and related equipment for the transport of goods or merchandise in international traffic are taxable only in the State of residence of the enterprise.

Paragraph (4) provides that the provisions of paragraphs (1) and (3) apply to profits from the participation in a pool, a joint business, or an international operating agency.

Paragraphs (1) through (4) of this Article are taken from the U.S. Model.

Paragraph (5) was inserted at the request of Malta. It provides that, notwithstanding any other provisions of this Article, the United States may tax the shipping profits, as well as gains from the sale or exchange of a ship, derived by a Malta corporation if (1) such corporation benefits in Malta from the provisions of section 86 of the Merchant Shipping Act of 1973 or any similar provision and (2) more than 25 percent of the voting stock of such corporation is owned, directly or indirectly, by persons not resident in Malta. Under section 86, nonresidents of Malta may establish a Malta corporation to operate ships and, if certain tests are met, the income of the corporation is exempt from Malta tax. Malta is concerned that it not, by virtue of section 86, become an international tax haven with respect to shipping operations. This right of the United States to tax, however, may not be exercised in a specific instance if the Malta corporation is exempt from tax under section 883 of the Code.

In notes exchanged at the time of the signing of the Treaty, it is made clear that Malta corporations subject to the provisions of paragraph (5) are subject to Article 7 (Business Profits). Thus, U.S. tax will apply only to income attributable to a permanent establishment which the Malta corporation has in the United States and which is not otherwise exempt under section 883 of the Code.

Article 9. ASSOCIATED ENTERPRISES

This Article complements section 482 of the Code and confirms the right of the United States to allocate items of income, deduction, credit, or allowance in certain cases. Under paragraph (1), if conditions are made or imposed between related enterprises in their commercial or financial relations which differ from those that would be made between independent enterprises, any profits that would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions have not so accrued may be included in the profits of that enterprise and taxed accordingly. Enterprises are related for purposes of the Treaty where an enterprise of a Contracting State participates directly or indirectly in the management, control, or capital of an enterprise of the other Contracting State, or the same persons participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State.

Paragraph (2) describes the consequences of an adjustment made by a Contracting State in accordance with paragraph (1). The other Contracting State will make an appropriate adjustment to the amount of tax which it charged to the related enterprise, and in determining the amount of such adjustment, the other provisions of the Treaty shall be taken into account. Thus, if as a result of the adjustment one enterprise is treated as having made a distribution of profits to the other, the provisions of Article 10 (Dividends) may apply to the deemed distribution. If necessary, the competent authorities are authorized to consult to resolve any differences in the application of these provisions, such as a disagreement over the appropriateness of an adjustment.

Paragraph (3) provides that the provisions of paragraph (1) shall not limit the application of any internal law provisions in either Contracting State designed to place transactions between related enterprises on an arm's-length basis. Thus, this Article does not limit the right of the United States to apply section 482 of the Code, even when such application extends beyond the provisions of Article 9.

Article 10. DIVIDENDS

Under paragraph (1), dividends paid by a company which is a resident of one Contracting State to a shareholder resident in the other Contracting State may be taxed in the State of residence of the recipient.

Dividends may also be taxed in the State in which the company paying the dividends is resident, but not in excess of the rates specified in paragraph (2). In the case of dividends paid by a United States company, paragraph (2)(a) provides that the rate of United States tax shall not exceed 5 percent of the gross amount of the dividends when the beneficial owner is a company resident in Malta which owns, directly or indirectly, at least 10 percent of the voting stock of the company paying the dividends. If this test is not met, but the beneficial owner of the dividends is a resident of Malta, the U.S. tax rate may not exceed 15 percent of the gross amount of the dividends. Article 10 of the U.S. Model contains the same rules. Unlike the U.S. Model, however, the rules in the Treaty are not reciprocal.

Paragraph (2)(b) provides the limit for Malta tax on dividends paid by a Malta company to a U.S. resident who is the beneficial owner of the dividends. Under this provision, the Malta tax is limited to that chargeable on the company paying the dividends in the year during which distribution is made. This provision reflects Malta's internal law system of integrating the corporate tax on distributed profits with the shareholder tax. Under the Malta system, the general corporation tax rate is 32.5 percent, although in some circumstances lower rates may apply (see below). When a dividend is paid, the shareholder (domestic or foreign) receives a credit for the tax paid at the corporate level on the income out of which the dividend is paid. The paying corporation may specify the particular year's income out of which the dividend is paid.

The following example illustrates the Malta system in a simple case, where the dividend is paid out of fully taxed income:

Malta corporate profits	100.0
Malta corporate taxes	32.5
After tax profits	67.5
Dividends declared (from current year's income)	67.5
Gross-up of shareholder's income	32.5
Shareholder's taxable income	100.0
corporate shareholder	
Malta tax (32.5% x 100.0)	32.5
credit	32.5
net tax	0.0
individual shareholder	
Malta tax (assume 40%)	40.0
credit	32.5
net tax	7.5

Individual rates in Malta range from zero to 65 percent. If an individual shareholder is subject to Malta tax at a rate below 32.5 percent, he is entitled to a refund.

If a dividend is paid out of income which has been taxed at a rate below 32.5 percent, the gross-up is at the 32.5 percent rate, but the credit allowed is limited to the tax actually paid. A tax below 32.5 percent may be paid because of foreign tax relief or because corporate tax is imposed at only 15 percent on retained profits if the paying corporation retains and reinvests at least 65 percent of its profits. The effect of this treatment of dividends paid out of income which has been taxed at a reduced rate is to collect from the shareholder the reduction in tax at the corporate level. Companies can largely avoid this effect by declaring their dividends to be out of income from years in which full tax is paid.

Thus, under paragraph (2)(b), for United States corporate shareholders there will be no additional tax and no refunds. For individual residents of the United States, if the Malta marginal tax rate applicable to the shareholder is below 32.5 percent, he may, under Malta law, file for a refund. If his rate exceeds 32.5 percent, no additional tax will be payable because of the rate limitation in the Treaty.

Paragraph (3) defines "dividends" as income from shares or other rights participating in profits, but not debt-claims, and income from other corporate rights taxed in the same way as income from shares under the tax law of the State of which the company making the distribution is a resident. Each Contracting State is permitted to apply its domestic law rules for differentiating dividends from interest and other disbursements. This definition is also found in the U.S. Model.

Paragraph (4) provides that where the shares or holding in respect of which the dividends are paid is effectively connected with a permanent establishment or fixed base of the recipient in the country of which the company paying the dividends is a resident, then the dividends are attributable to the permanent establishment or fixed base and are taxable in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), rather than under the provisions of paragraphs (1) and (2) of this Article.

Paragraph (5) provides, as a general rule, that a Contracting State may not impose tax on dividends paid by a company which is a resident of the other Contracting State. There are three exceptions to this rule: (1) where the dividends are paid to a resident of the first-mentioned State, (2) where the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or fixed base in the first State, or (3) where the dividends are paid out of profits attributable to one or more permanent establishments of the paying company in the first State, provided that at least 50 percent of that company's gross income from all sources was attributable to such profits. Where only the third of these three conditions applies, if the dividends are beneficially owned by a resident of the other Contracting State, the tax which may be imposed on such dividends is subject to the limitations provided in paragraph (2) of this Article.

For example, if a company which is a resident of Malta is doing business in the United States and pays dividends, those dividends may be taxed by the United States (1) if paid to a resident of the United States; (2) if the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base in the United States; or (3) if the dividends are paid out of profits attributable to a permanent establishment of the Malta company in the United States to which at least 50 percent of the company's gross income from all sources was attributable. The last case preserves the United States tax on dividends paid by a foreign corporation which are considered to have a U.S. source under section 861(a)(2)(B) of the Code. If beneficially owned by a resident of Malta, such dividends would be subject to U.S. tax at the reduced rates provided in paragraph (2)(a). It is to be noted that paragraph (5) is overridden by the saving clause of paragraph (3) of Article 1 (Personal Scope), so that, for example, the United States may tax a U.S. citizen on this type of income in all cases.

Article 11. INTEREST

This Article deals with the taxation by one Contracting State of interest derived and beneficially owned by a resident of the other Contracting State.

Paragraph (1) provides that the State in which the beneficial owner is resident may tax the interest. Paragraph (2) provides that the State in which the interest arises may also tax the interest, but its tax may not exceed 12.5 percent of the gross amount of the interest. Paragraph (3) provides an exception to the rule in paragraph (2) under which interest derived by the other Contracting State or an instrumentality thereof, not subject to tax on its income by that other State, will be exempt from tax in the Contracting State in which it arises.

Under Malta law, the withholding tax on nonresidents, like the withholding tax on residents, is provisional. The withholding may be a final payment for a nonresident if the taxpayer chooses not to file a return reporting his net income subject to taxation in Malta. But, if the tax due at ordinary rates on net income is less than the amount withheld, the taxpayer is entitled to a refund. In the case of interest, the statutory provisional withholding rate is 32.5 percent. Under paragraph (2), this rate is reduced to 12.5 percent. If the tax on net income at ordinary rates (32.5 percent for corporate income recipients and zero to 65 percent for individuals) proves to be less than 12.5 percent of gross income, the U.S. interest recipient is entitled to a refund upon the filing of a return. This treatment is confirmed in paragraph (3) of an explanatory note exchanged at the time of the signing of the Treaty and attached thereto.

Paragraph (4) contains the definition of interest found in the U.S. Model.

Paragraph (5) provides that interest on a debt-claim which is effectively connected with a permanent establishment or fixed base which the beneficial owner of the interest, a resident of a Contracting State, maintains in the other Contracting State, is attributable to the permanent establishment or fixed base and is taxable in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services) rather than under this Article.

Paragraph (6), which identifies the place where interest is deemed to arise, is the same as the U.S. Model. Interest is deemed to arise in a Contracting State where the payer is that State or a political subdivision or local authority thereof, or if the payer is a resident of that State. If, however, the interest is incurred in connection with a permanent establishment or fixed base in a Contracting State, and the interest is borne as a deduction by that permanent establishment or fixed base, then the interest is deemed to arise in that State, regardless of the residence of the payer.

If excessive interest is paid pursuant to a special relationship between the payer and the person beneficially owning the interest or between both of them and a third person, paragraph (7) states that the provisions of Article 11 shall not apply to the excess portion of the payment. The excess portion may be taxed by each Contracting State in accordance with its own law, including the Treaty where applicable. In the case of the United States, the excess portion may, for example, be taxed as a dividend, in which case the provisions of Article 10 (Dividends) will apply.

Paragraph (8) states the conditions under which a Contracting State may tax interest paid by a resident of the other Contracting State. Under paragraph (8)(a), such a tax may be applied if the interest either arises in, or is paid to a resident of, the first Contracting State. Thus, if a resident of Malta pays interest to a resident of the United States, the United States may tax that interest; and if a resident of Malta pays interest which is incurred in connection with a permanent establishment which the Malta resident maintains in the United States and which is borne by that permanent establishment, the United States may tax the interest.

Under paragraph (8)(b), the first Contracting State may also tax interest if the debt-claim in respect of which the interest is paid is effectively connected with a permanent establishment or fixed base situated in that State. Thus, if a resident of Malta pays interest to any person and the loan in respect of which the interest is paid is effectively connected with a permanent establishment in the United States, the United States may tax that interest under Article 7 (Business Profits).

Paragraph (8) is overridden by the saving clause of paragraph (3) of Article 1 (Personal Scope), so that, for example, the United States may tax a U.S. citizen on this type of income in all cases.

Article 12. ROYALTIES

Paragraph (1) provides that cultural royalties beneficially owned by a resident of a Contracting State shall be exempt from tax by the other State. Cultural royalties are defined in paragraphs (3)(a) and (c). This paragraph is subject to the saving clause of paragraph (3) of Article 1 (Personal Scope). Thus, cultural royalties derived and beneficially owned by a resident of Malta who is also a U.S. citizen may, notwithstanding paragraph (1), be taxed by the United States.

Paragraph (2) provides that industrial royalties (defined in paragraphs (3)(b) and (c)) which arise in a Contracting State and which are beneficially owned by a resident of the other Contracting State may be taxed by both States. However, the tax in the State in which the royalties arise may not exceed 12.5 percent of the gross amount of the royalties.

The system in Malta for taxing royalties is the same as that for interest. A withholding tax of 32.5 percent is imposed, as a provisional payment, on all royalty recipients, resident and nonresident alike. The statutory withholding rate of 32.5 percent is reduced, under paragraph (2)(b), to a maximum of 12.5 percent. If the ordinary Malta tax rate (32.5 percent for a U.S. company and zero to 65 percent for a U.S. resident individual) applied to the net income subject to tax in Malta, after the allowance of expenses, yields a tax liability which is less than the amount withheld, the taxpayer may file with the Malta authorities for a refund. This is explained in paragraph (3) of an exchange of notes attached to the treaty.

Paragraph (3) contains definitions of various kinds of royalties. Paragraph (3)(a) defines cultural royalties as payments for the use of or the right to use copyrights of literary, artistic, or scientific works. Payments for the use of motion picture films are not included in the definition of cultural royalties.

Paragraph (3)(b) defines industrial royalties as payments for the use of or the right to use motion picture films or films or tapes for radio or television broadcasting, patents, designs, models, plans, secret processes or formulae, trademarks or other similar property or rights. Also included in the definition are payments for the supply of scientific, technical, industrial or commercial knowledge or information held by the supplier, and for services, to the limited extent that the services constitute assistance of an auxiliary or subsidiary nature supplied in order to enable the recipient to use the rights or knowhow to which the Article otherwise applies. For example, payments by a licensee to a licensor of a process for training the licensee's employees in the use of the process would, under this provision, be treated as royalty income. In all other cases, income from the performance of services would be subject to the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services).

Paragraph (3)(c) extends the definition of cultural and industrial royalties to include gains from the sale, exchange, alienation of property or rights, described in paragraphs (3)(a) and (b) if the amount realized is contingent on the productivity, use, or alienation of such property or rights.

The definition of royalties differs in substance from that in the U.S. Model by the inclusion of motion picture royalties (which are treated as business profits in the U.S. Model) and of payments for the supply of auxiliary and subsidiary services.

Paragraph (4) provides that where the right or property in respect of which the royalties are paid is effectively connected with a permanent establishment or fixed base maintained by the beneficial owner of the royalties in the other Contracting State, then the royalties are attributable to the permanent establishment or fixed base and shall be taxed in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services) rather than in accordance with the provisions of this Article.

Paragraph (5) identifies the State in which royalties are deemed to arise. The general rule is that royalties arise in a Contracting State when the payer is that State itself or a political subdivision, local authority, or resident of that State. Since this rule may conflict with the U.S. statutory rule, which sources royalties in the State in which property or rights are used, it was deemed necessary to provide an exception to the general rule with respect to the use of property in a Contracting State. Under this exception, payments for the use of or the right to use property or rights in a Contracting State are deemed to arise in the State in which they are used. Thus, if a U.S. resident licensor receives royalties from a resident of Malta for the use of a patent in Malta or in a third country, the royalty will be deemed to arise in Malta. If, however, the Malta resident uses the patent in the United States, the royalty will arise in the United States. Because of the exception, the United States will not be required to credit a Malta tax on an item of income which, under U.S. law, would have a U.S. source.

Under paragraph (6), if excessive royalties are paid pursuant to a special relationship between the payer and the beneficial owner of the royalty or between both of them and a third person, the provisions of this Article shall not apply to the excess portion of the payment. The excess portion may be taxed in each Contracting State in accordance with its own law, including the Treaty where applicable. In the case of the United States, the excess portion may, for example, be taxed as a dividend, in which case the provisions of Article 10 (Dividends) will apply.

Article 13. CAPITAL GAINS

This Article contains the same provisions as are found in the U.S. Model (Article 13), with the addition of a provision in paragraph (1), as described below.

Paragraph (1) provides that gains from the alienation of immovable property are taxable in the State where the property is situated. It further provides that gains from the alienation of shares of a company whose assets consist principally of immovable property may be taxed in the State in which that immovable property is situated.

Paragraph (2) provides that a Contracting State may tax gains from the alienation of movable property which is part of the property of a permanent establishment or fixed base in that State maintained by a resident of the other Contracting State.

Paragraphs (1) and (2) do not confer an exclusive right to tax. Such gains may also be taxed by the State of residence, subject to the provisions of Article 24 (Relief From Double Taxation).

Under paragraph (3), gains derived by an enterprise of one Contracting State from the alienation of ships, aircraft, or containers which it operates in international traffic are taxable only in the State of residence. Gains described in paragraph (3)(c) of Article 12 (Royalties) are not taxable in accordance with this Article but, instead, in accordance with the provisions of Article 12.

Paragraph (4) provides that gains from the alienation of any property other than property identified in paragraphs (1), (2), and (3) are taxable only in the State of which the alienator is a resident.

The term "gains" includes amounts treated as capital ganins and as ordinary income.

Though paragraphs (3) and (4) provide an exclusive right to tax in the State of residence, these provisions are subject to the saving clause of paragraph (3) of Article 1 (Personal Scope). Thus, a resident of Malta who is a citizen of the United States may be subject to United States tax on gains from the alienation of property described in paragraphs (3) and (4) notwithstanding the provisions of these paragraphs.

Article 14. INDEPENDENT PERSONAL SERVICES

The Treaty provides separate articles dealing with the taxation of income from independent and dependent personal services. Independent personal services are, in general, services performed by an individual for his own account where he receives the income and bears the losses arising from such services. Income from services in which capital is a material income-producing factor, however, will generally be governed by the provisions of Article 7 (Business Profits). Generally, services rendered by physicians, lawyers, engineers, architects, dentists, artistes, athletes, and accountants who perform personal services as sole proprietors or partners are independent personal services, whereas services performed as an employee or as an officer of a corporation constitute dependent personal services.

Paragraph (1) of this Article provides that income derived by an individual who is a resident of a Contracting State from the performance of personal services in an independent capacity shall generally be taxable only in that State. However, such income may also be taxed in the other Contracting State if the services are performed in that other State and either 1) the individual is present in that other State for more than 90 days in the taxable year; 2) the income is attributable to a fixed base in that other State which the individual has regularly available for the purpose of performing his activities; or 3) the remuneration derived from residents of that other State exceeds $10,000 during the taxable year. In the third case, if the remuneration exceeds $10,000, the entire amount, and not just the excess, may be taxed by that other State.

Paragraph (1) differs from the comparable provision in the U.S. Model by the reduction of the time threshold in subparagraph (a) from 183 days to 90 days and by the addition of a dollar threshold in subparagraph (c). This is the type of change from the U.S. Model to which U.S. negotiators frequently agree in negotiations with developing countries.

Paragraph (2), which is based on paragraph 2 of Article 14 of the OECD Model, illustrates the kinds of services covered by this Article. Although the U.S. Model does not define the term "personal services," the addition of the definition in the Treaty does not alter the substantive effect of the Article. The term "fixed base" is not defined, but a fixed base is generally understood to be similar to a permanent establishment.

Article 15. DEPENDENT PERSONAL SERVICES

This Article is essentially the same as Article 15 of the U.S. Model. It provides that, subject to the provisions relating to directors' fees (Article 17), pensions and annuities (Article 19), and income from government services (Article 20), remuneration derived by a resident of a Contracting State in respect of an employment may be taxed by the other State only to the extent that the remuneration is for employment exercised in that other State. Even in that event, the remuneration is taxable only in the State of residence if the recipient is present in the other State for not more than 183 days in the taxable year, he is paid by or on behalf of an employer who is not a resident of the other State, and the remuneration is not borne as a deduction by a permanent establishment or fixed base of the employer in the other State.

Paragraph (3) provides a special rule for members of the regular complement of ships or aircraft operated in international traffic. Remuneration for such services is taxable in the Contracting State of which the enterprise operating the ship or aircraft is a resident.

Article 16. INVESTMENT OR HOLDING COMPANIES

This Article, which is the same as the U.S. Model, provides that a company which (1) is a resident of one Contracting State, (2) 25 percent or more of whose capital is owned directly or indirectly by persons who are not individual residents of that Contracting State and (3) which derives dividends, interest, or royalties arising within the other Contracting State, shall not be entitled to claim the benefits of Article 10 (Dividends), 11 (Interest), or 12 (Royalties) if, by reason of special measures, the tax imposed by the first-mentioned Contracting State with respect to such dividends, interest, or royalties is substantially less than the tax generally imposed by that State on company business profits. The source of dividends, interest, and royalties, for purposes of this Article, is determined in accordance with paragraph (3) of Article 24 (Relief From Double Taxation).

The purpose of this Article is to prevent residents of a third country from taking advantage of the reduced rates of withholding provided by the Treaty where one of the Contracting States provides preferential rates of tax for investment or holding companies deriving foreign source income. In the absence of this Article, residents of a third country could organize a corporation in the Contracting State extending preferential rates for the purpose of making investments in the other Contracting State. The combination of low tax rates in the Contracting State of residence and the reduced rates or exemptions provided in the Treaty in the Contracting State of source would enable such third country residents to realize unintended benefits.

Article 17. DIRECTORS' FEES

This Article provides that, notwithstanding the provisions of Articles 14 (Independent Personal Services) and 15 (Dependent Personal Services), a resident of a Contracting State who is a director of a company of the other Contracting State may be taxed by that other State on the fees which he derives in his capacity as a director (not including payments in his capacity as an officer or employee) to the extent that such fees exceed reasonable compensation to all directors of the company for attendance at meetings in that other State. Such excess fees may be taxable whether or not the director is physically present in the other State in connection with his duties as a director.

Article 18. ARTISTES AND ATHLETES

This Article deals with the taxation of income derived by entertainers, musicians, and athletes from the performance of services. The Article applies in cases where an artiste or athlete performs services on his own behalf and in cases where services are performed on behalf of another person, as an employee or pursuant to any other arrangement.

Paragraph (1) states the general rule that, notwithstanding the provisions of Article 14 (Independent Personal Services) and Article 15 (Dependent Personal Services), income derived by entertainers such as theatre, motion picture, radio, or television artistes, and musicians, and athletes, for their personal activities as such, may be taxed in the Contracting State where those services are exercised if (1) the artiste or athlete is present in that State for a period or periods aggregating 90 days or more during the taxable year, or (2) the income for such services exceeds $500 per day of performance (including rehearsal time) or $5,000 for the taxable year. If the amount of income exceeds $500 per day or $5,000 per year, the full amount, and not just the excess, is subject to tax in the State in which the services are performed.

Income derived from services rendered by producers, directors, technicians, and others who are not artistes and athletes is taxable in accordance with the provisions of Article 14 (Independent Personal Services), or Article 15 (Dependent Personal Services), as the case may be.

Paragraph (1) differs from the comparable provision in the U.S. Model (paragraph (1) of Article 17) which contains no time threshold and sets the dollar threshold at $15,000 of gross receipts (including reimbursed expenses). The somewhat broader source country taxation authorized by the Treaty reflects Malta's status as a developing country.

Paragraph (2), which is taken from the U.S. Model, deals with cases in which income in respect of the activities of an entertainer or athlete accrues to a person other than, or in addition to, the entertainer or athlete. Foreign entertainers commonly perform services in the United States as employees of, or contractors for, a company or other person. That person may act as the nominal recipient of the income in respect of the entertainer's services and the entertainer may act as its "employee" or "contractor." In such cases, the company may escape taxation in respect of those services under the provisions of Article 7 (Business Profits) because it does not have a permanent establishment in the United States. The entertainer may also escape taxation by taking a small salary while in the United States and then either receiving payment in a later year when the income is subject to little or no tax, or liquidating the company after the services are performed.

Paragraph (2) provides that income in respect of the personal activities of an artiste or athlete which accrues to the benefit of another person (including a company, trust, or partnership of either Contracting State or any third State), may, notwithstanding the provisions of Articles 7 (Business Profits), 14 (Independent Personal Services), and 15 (Dependent Personal Services), be taxed in the Contracting State in which the activities of the entertainer or athlete take place. Thus, such other person could not claim the permanent establishment protection otherwise provided by Articles 5 (Permanent Establishment) and 7 (Business Profits).

For purposes of paragraph (2), income is considered to accrue to another person if that other person has control over, or the right to receive, gross income derived in respect of the services of an entertainer or athlete. This rule applies regardless of whether the other person is a "sham" or conduit. Income will not, however, be deemed to accrue to the benefit of another person where it is established to the satisfaction of the competent authority of the Contracting State in which the services are performed that neither the artiste or athlete, nor related persons, participate directly or indirectly in the profits of such other person in any manner, including the receipt of deferred compensation, bonuses, fees, dividends, partnership distributions, or other distributions. Depending on the facts in a particular case, a person may be considered to be related to an artiste or athlete if he is an employee or agent of the artiste or athlete or if he is regularly employed by the artiste or athlete in an advisory capacity, such as his attorney, accountant, or investment advisor. Paragraph (2) does not affect the rule of paragraph (1), that applies to the artiste or athlete himself.

This Article is subject to the saving clause in paragraph (3) of Article 1 (Personal Scope). Thus, an artiste or athlete who is a resident of Malta and a citizen of the United States who performs in the United States would, notwithstanding this Article, be fully subject to U.S. tax.

Article 19. PENSIONS AND ANNUITIES

This Article is narrower in scope than Article 18 of the U.S. Model. Paragraph (1) provides that, subject to the provisions of paragraph (2) of Article 20 (Government Services), pensions and similar remuneration beneficially derived by a resident of one Contracting State in consideration of past employment are taxable only in the State of residence. The reference to paragraph (2) of Article 20 places the treatment of pensions for government service under the rules of that Article rather than this one.

The U.S. Model provisions stating that social security payments and other public pensions paid by one of the Contracting States to a resident of the other State or to a United States citizen are taxable only in the paying State are omitted from this Article. Malta was unwilling to agree to exclusive taxation of social security benefits by the paying State. Such payments, including social security payments and U.S. railroad retirement benefits are, therefore, covered by Article 23 (Other Income) and taxed only in the State of residence.

Paragraph (2), as in the U.S. Model, provides that annuities beneficially derived by a resident of a Contracting State are taxable only in that State.

The U.S. Model (Article 18) provides additional paragraphs (3) and (4) which deal with alimony and child support payments. These paragraphs are deleted in the Treaty. Alimony and child support payments therefore are covered by Article 23 (Other Income), and are taxable only in the State of residence of the recipient.

Article 20. GOVERNMENT SERVICE

This Article is the same as Article 19 of the U.S. Model. Paragraph (1) provides that, as a general rule, remuneration (other than pensions) paid by a Contracting State or a political subdivision or local authority thereof to any individual for services rendered shall be taxable only in that State. It also provides an exception, however, under which such remuneration shall be taxable only in the other Contracting State if the services are rendered in that other State by an individual who is a resident of that other State and who either is also a national of that State or did not become a resident of that State solely for the purpose of performing the services (for example, if the individual was already a local resident when hired by the first State).

Paragraph (1) also includes a rule for the treatment of the spouse or dependent children of an individual who, under the above rules, is taxable only in the employing State. If the spouse or a dependent child of such an individual also becomes an employee of the first Contracting State after having become resident in the other Contracting State, that spouse or child would also be exempt from tax by the other Contracting State on the remuneration for those services. This special rule covers the case where the wife or child of a U.S. Embassy employee in Malta, for example, is employed by the Embassy after having established residence there. This rule is consistent with paragraph (5) of Article 4 (Fiscal Residence), under which such an individual would be considered a resident of the United States (the country of nationality) for all purposes under the Treaty.

Paragraph (2) provides that a pension paid by a Contracting State or a political subdivision or a local authority thereof to any individual as consideration for services rendered to that State or subdivision or local authority is taxable only in that State unless the recipient is both a national and a resident of the other State. In the latter case, such income is taxable only in the other Contracting State.

Under paragraph (3), the provisions of this Article apply only to remuneration and pensions in respect of services of a governmental nature. Remuneration and pensions in respect of services performed in connection with a business carried on by a Contracting State or a political subdivision or local authority thereof are taxable under the provisions of Article 14 (Independent Personal Services), 15 (Dependent Personal Services), 18 (Artistes and Athletes), or 19 (Pensions and Annuities). Whether functions are of a governmental nature may be determined by reference to the concept of a governmental function in the State in which the income arises.

Pursuant to paragraph (4)(b) of Article 1 (Personal Scope), the benefits of this Article conferred by a Contracting State are not subject to the saving clause of paragraph (3) of Article 1, with respect to individuals who are neither citizens of nor have immigrant status in that State. In other cases, the saving clause does apply.

Article 21. TEACHERS

This Article was inserted at the request of Malta. It does not appear in the U.S. Model or the OECD Model.

The Article provides that when a resident of one of the Contracting States visits the other Contracting State for a period not exceeding two years for the purpose of teaching or carrying out advanced study or research at a university, college, school, or other educational institution in that other State, the remuneration paid to him from sources outside that other State for a period not exceeding two years from the date of arrival shall be exempt from tax by that other State. Under paragraph (2) this exemption does not apply to income from research carried on primarily for private benefit. If the two year period is exceeded, the exemption is lost for the entire period.

The benefits conferred by the host State under this Article are not subject to the saving clause in paragraph (3) of Article 1 (Personal Scope) with respect to individuals who are neither citizens of nor have immigrant status in that State. In other cases, the saving clause does apply. Thus, a citizen of the United States who is a resident of Malta and visits the United States for less than two years to teach in a university does not benefit from a U.S. exemption pursuant to this Article. However, if the individual is not a citizen of the United States, the fact that he might acquire residence (but not immigrant) status in the United States for tax purposes does not deny him the benefits of the Article.

Article 22. STUDENTS AND TRAINEES

This Article is the same as Article 20 of the U.S. Model. It provides in paragraph (1) that a resident of one of the Contracting States who goes to the other Contracting State for the purpose of full-time education or training shall be exempt from tax in that other Contracting State on payments made to him from sources outside that State for the purpose of his maintenance, education, or training.

Paragraph (2) provides that such a student or trainee may elect to be treated for tax purposes as a resident of the State which he is visiting for the purposes of education or training. Under this rule, a Malta student or trainee in the United States may elect to be taxed on his worldwide income in the United States and claim the same deductions and personal exemptions which are available to U.S. residents. If married, he would be entitled to make an election under section 6013(g) to file a joint return with a nonresident alien spouse.

Such an election would benefit a student or trainee with limited income, especially if he is supporting dependents, since a nonresident alien is only allowed one personal exemption and may not take advantage of the zero bracket amount. The election would presumably not be made by a student or trainee with large amounts of foreign source income, because without the election, foreign source income would not be subject to U.S. tax. Once the election is made, it may not be revoked except with the consent of the competent authority of the host State. If an election is made, the individual would be considered a resident of the United States for purposes of this Treaty.

The benefits conferred by the host State under this Article are not subject to the saving clause of paragraph (3) of Article 1 (Personal Scope), with respect to individuals who are neither citizens of nor have immigrant status in that State. In other cases, the saving clause does apply. Thus, a citizen of the United States who is a resident of Malta and is in the United States to study at an American university does not benefit from the U.S. exemption accorded by this Article. However, if the individual is not a citizen of the United States, the fact that he may acquire residence (but not immigrant status) in the United States for tax purposes does not deny him the benefits of the Article.

Article 23. OTHER INCOME

This Article is the same as Article 21 of the U.S. Model. Paragraph (1) provides the general rule that any income of a resident of a Contracting State which is not covered by other articles of the Treaty shall be taxable only in the State of residence.

The scope of this Article is not confined to income having a source in the other Contracting State but extends, as well, to income from sources in third countries. Moreover, the rule applies irrespective of whether the State of residence exercises its right to tax the income covered by the Article.

The specific items of income covered by this Article include social security payments, alimony, child support payments, prizes, and awards. Most other types of income are specifically dealt with in other articles of the Treaty.

This Article is subject to the saving clause in paragraph (3) of Article 1 (Personal Scope).

Paragraph (2) excepts from the rule of paragraph (1) income derived by a resident of a Contracting State which is effectively connected with a permanent establishment or fixed base of that resident in the other Contracting State. In such cases, the income is covered instead under the provisions of the articles dealing with business profits (Article 7) independent personal services (Article 14), or artistes and athletes (Article 18). An exception to the exception established in paragraph (2) is provided for income from immovable property, as defined in paragraph (2) of Article 6 (Income from Immovable Property (Real Property)). Thus, if a U.S. resident has a permanent establishment in Malta, income from U.S. or third country sources which is effectively connected with the permanent establishment (other than real property income) would be subject to tax in Malta. Effectively connected income from real property situated in the U.S. or a third country, on the other hand, would not be subject to tax in Malta.

Article 24. RELIEF FROM DOUBLE TAXATION

Paragraph (1) of this Article is taken from the U.S. Model. It provides that the United States shall give a foreign tax credit for income taxes paid to Malta, subject to the limitations provided in U.S. law. The taxes referred to in paragraphs (2)(b) and (3) of Article 2 (Taxes Covered) are considered income taxes for purposes of the credit. The Treaty guarantee of a foreign tax credit is independent of the statutory grant of a credit under the Code, but the amount of the credit to be allowed is determined in accordance with the limitations provided in United States law, as those limitations may be changed from time to time. The Article provides a credit both for taxes imposed on the recipient and an indirect credit to a United States company owning at least 10 percent of the voting stock of the Malta company for taxes paid with respect to the profits of the Malta company out of which the dividends are paid.

Paragraph (2) provides that, subject to the provisions of Malta law regarding the allowance of a credit, Malta will allow a credit against Malta tax for United States tax on income from sources in the United States which, in accordance with the provisions of the Treaty, is also taxable in Malta. The paragraph further provides a credit, not otherwise provided under Malta law, for the underlying United States corporate tax on the profits out of which dividends are paid in the case of dividends from a United States company to a Malta company which owns at least 10 percent of the voting stock of the U.S. company.

Paragraph (3), as in the U.S. Model, identifies the source of items of income for purposes of this Article. It is necessary to know the source of income in order to compute the credit under the Treaty. The United States credit is limited to the United States tax on income from sources outside the United States, and the Malta credit is limited to Malta tax with respect to income from sources in the United States. A taxpayer may, for any year, claim a foreign tax credit under the rules of the Code.

The source of dividends is the State of residence of the paying corporation, unless the dividends are described in paragraph (5)(c) of Article 10 (Dividends). If the dividends are paid out of profits attributable to one or more permanent establishments and if at least 50 percent of the company's gross income from all sources was attributable to such profits, dividends have their source in the State where the permanent establishment of the company paying the dividends are situated.

The source of interest is the State specified in paragraph (6) of Article 11 (Interest) and the source of royalty income is the State specified in paragraph (5) of Article 12 (Royalties).

All items of income other than dividends, interest, and royalties, derived by a resident of a Contracting State, are deemed to have a source in the other Contracting State if that income may be taxed in that other State in accordance with the Treaty. The only exception is any item of income which may be taxed by the United States solely by reason of the saving clause in paragraph (3) of Article 1 (Personal Scope) because the recipient is a citizen of the United States.

The saving clause in paragraph (3) of Article 1 (Personal Scope) does not apply to this Article. Thus, the provisions of this Article may be relied upon by a citizen or resident of a Contracting State.

Article 25. NON-DISCRIMINATION

The provisions of this Article are substantially the same as those of paragraph 1 and paragraphs 3 through 6 of Article 24 of the U.S. Model. Paragraph 2 of Article 24 of the U.S. Model contains a definition of the term "nationals" which in the Treaty appears, in a broadened form, in paragraph (1)(e) of Article 3 (General Definitions). As noted below, paragraph (3) deletes some of the material found in the comparable paragraph (paragraph 4) of the U.S. Model.

Paragraph (1) provides that nationals, including legal persons as well as individuals, shall not be treated less favorably with respect to taxation and connected requirements by the other Contracting State than are nationals of that other Contracting State in the same circumstances. Nationals who are subject to tax on their worldwide income by a Contracting State are not in the same circumstances as nationals not taxed on their worldwide income by that State. Thus, United States citizens who are not residents of the United States are not in the same circumstances with respect to United States taxation as nationals of Malta who are not citizens of the United States. The United States, therefore, is not obligated to treat a national of Malta who is a resident of a third country in the same manner as a United States national who is a resident of that same third country.

Paragraph (2) provides that a Contracting State may not impose more burdensome taxes on a permanent establishment of an enterprise of the other State than it imposes on its own enterprises carrying on the same activities. This provision, however, does not oblige the first-mentioned State to grant personal allowances, etc., to residents of the other State which it grants to its own residents.

Paragraph (3) prohibits discrimination in the allowance of deductions. Interest, royalties, and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State must be deductible for determining taxable profits under the same conditions as if they had been paid to a resident of the first-mentioned State. The U.S. Model contains language explaining that the term "other disbursements" includes a reasonable allocation of executive and general administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related enterprises. That sentence was deleted from the Treaty at Malta's request; but no change in substance is intended. Paragraph (3) also provides that debts incurred by an enterprise of a Contracting State to a resident of the other Contracting State shall be deductible in determining taxable capital under the same conditions as if the debts had been contracted to a resident of the first-mentioned State. This provision is included because, as paragraph (5) states, this Article applies to taxes of every kind and description imposed by all levels of government.

Paragraph (4) requires that a Contracting State not impose more burdensome taxation on a domestic enterprise owned by residents of the other Contracting State than it imposes on similar enterprises which are domestically owned.

The provisions of this Article do not override the right of the United States to impose the tax provided in Code section 897 (relating to gains derived by nonresidents aliens or foreign corporations from U.S. real property interests).

The saving clause in paragraph (3) of Article 1 does not apply to this Article. Thus, a Contracting State may not deny any rights conferred by this Article to its citizens and residents.

Article 26. MUTUAL AGREEMENT PROCEDURE

This Article is substantially the same as Article 25 of the U.S. Model.

Paragraph (1) provides that a person who considers that the actions of one or both of the Contracting States result in taxation not in accordance with the Treaty may present the case to the competent authority of the State of which the person is a resident or national. The person need not be a resident of one of the Contracting States, and need not first have exhausted the remedies available under the domestic laws of the Contracting States.

Paragraph (2) provides that the competent authority, if it considers the objection to be justified and if it is not able to arrive at a solution itself, shall endeavor to resolve the case by mutual agreement with the competent authority of the other Contracting State in order to avoid taxation not in accordance with the Treaty. Any agreement reached shall be implemented without regard to any statutory time limits or other procedural limitations in the domestic laws of the Contracting States. Thus, if it is agreed that tax liability should be adjusted downward, a refund of the excess tax paid will be made even though the statute of limitations of the State called upon to make the refund may have expired. This waiver of the statute of limitations applies only for refunds and not for the imposition of additional taxes.

Paragraph (3) provides that the competent authorities shall endeavor to resolve by mutual agreement any difficulties or doubts which may arise in the interpretation or application of the Treaty. They may also consult together to reach agreements on rules, guidelines or procedures for the elimination of double taxation in cases not provided for in the Treaty. This paragraph gives examples of the kinds of issues to which the competent authorities may agree. These include: (a) the attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment in the other Contracting State; (b) the allocation of income, deductions, credits, or allowances between persons; (c) the characterization of items of income; (d) the application of source rules; and (e) the meaning of a term. An additional item, not found in the U.S. Model, provides that the competent authorities may agree to increases in any dollar amounts in the Treaty to reflect monetary or economic developments. Thus, if the competent authorities believe that, because of inflation, the $10,000 threshold for the taxation of independent personal service income in paragraph (1)(c) of Article 14 is no longer adequate, they may, without having to amend the Treaty formally, agree to a higher amount.

Paragraphs (4) and (5) provide that the competent authorities may communicate with each other directly for the purpose of reaching agreement in accordance with this Article and that they may prescribe regulations to carry out the purposes of the Treaty.

Article 27. EXCHANGE OF INFORMATION

Paragraphs (1) and (3) of this Article are identical to paragraphs 1 and 2, respectively, of Article 26 of the U.S. Model. Paragraph (2) of this Article is a shortened form of paragraph 3 of the U.S. Model. Since Malta was unwilling to undertake the obligation contained in paragraphs 4 and 5 of the U.S. Model, which deal with assistance in collection where treaty benefits accrue to persons not covered by the Treaty, these paragraphs were deleted. Paragraph 6 of the U.S. Model provides (as in paragraph 4 of Article 2 in the U.S. Model) that for the purposes of this Article, the Treaty applies to all national taxes. As noted in the explanation of Article 2 (Taxes Covered), Malta has no authority to exchange non-income tax information under an income tax treaty, and the paragraph was therefore not included.

Paragraph (1) provides that the competent authorities shall exchange such information as is necessary for carrying out the provisions of the Treaty or of their domestic laws concerning taxes covered by the Treaty. It also provides assurances that information so exchanged will be protected against disclosure in the same manner as information obtained under domestic laws. Information may be exchanged with respect to persons who are not residents of either Contracting State.

Paragraph (2) states that the State to which a request has been made shall provide information in specified forms so that the information may be usable in judicial proceedings of the requesting State. The specified forms include copies of unedited original documents, to the extent that such forms of information can be obtained under the laws and practices of the State to which the request is made when enforcing its own taxes.

Paragraph (3) explains that the obligation undertaken in paragraph (1) to exchange information does not require a Contracting State to carry out measures contrary to the laws and administrative practice of either State or to supply information not obtainable under either State's laws or in the normal course of its administration, or to supply information which would disclose trade secrets or other information the disclosure of which would be contrary to public policy. The Article authorizes a Contracting State to obtain information for the other Contracting State even if there is no tax liability in the State which is requested to obtain the information.

Article 28. DIPLOMATIC AGENTS AND CONSULAR OFFICERS

This Article corresponds to Article 27 of the U.S. Model. It provides that the Treaty shall not affect taxation privileges of diplomatic or consular officials under special agreements or international law.

Article 29. ENTRY INTO FORCE

Paragraph (1) provides that the Treaty be ratified by the Contracting States in accordance with their applicable procedures and that instruments of ratification be exchanged as soon as possible.

Paragraph (2) provides that the Treaty will enter into force upon the exchange of instruments of ratification. Once the Treaty enters into force it will have effect with respect to income or profits arising on or after the first day of January of the year of entry into force. Malta uses a "previous year" system of assessment under which, for example, tax payable in 1980 for the year 1979 is based on the income of 1978. If the treaty were to enter into force on December 1, 1980, it would be effective, with respect to Malta, for income arising in 1980. This would be the income on which the U.S. tax liability for 1980 is based and on which the 1981 Malta tax is based.

Article 30. TERMINATION

The Treaty shall remain in force indefinitely unless terminated by one of the Contracting States. Either Contracting State may terminate the Treaty after three years from the date on which it enters into force by giving at least six months' prior notice through diplomatic channels. In that event, the Treaty will cease to have effect with respect to income or profits arising on or after the first of January following the expiration of the six months' period of notice (i.e., if notice is given by June 30 of one year, the termination will be effective on January 1 of the following year). Under Malta's "previous year" system, termination would work as follows: If notice of termination is given in, say, June of 1985, the Treaty would terminate with respect to profits arising on or after January 1, 1986. For the United States, 1985 would be the last year of effect. For Malta the Treaty would, in effect, extend for one additional year, because 1985 income would determine 1986 taxes.

EXCHANGE OF NOTES

Notes, dealing with several issues, were exchanged at the time of the signing of the Treaty. In paragraph (1) the United States noted that Malta had stressed the need for provisions in the Treaty which would constitute special incentives to promote the flow of United States capital to Malta. While observing that the United States could not agree to such provisions, the United States did offer assurances that, when circumstances permit, the United States would be prepared to resume discussions with a view to incorporating provisions into the Treaty which will minimize the interference of the United States tax system with incentives offered by Malta. These provisions would have to be consistent with income tax policies of the United States Government regarding other developing countries.

Paragraph (2) elaborates on paragraph (5) of Article 8 (Shipping and Air Transport) of the treaty which provides that in some circumstances a Malta corporation which benefits from section 86 of the Merchant Shipping Act of 1976 may, notwithstanding the other provisions of the Article, be taxed by the United States. Paragraph (2) clarifies the fact that, in cases covered by paragraph (5) of Article 8, the provisions of Article 7 (Business Profits) shall apply, so that the United States may tax the shipping income of the Malta corporation only to the extent that income is attributable to a permanent establishment in the United States.

Paragraph (3) of the note relates to Article 11 (Interest) and 12 (Royalties) of the Treaty. It clarifies that the effective Malta tax on a U.S. recipient of interest or royalties from Malta may be below the 12.5 percent maximum rate specified in the Treaty. This follows from the fact that Malta will tax that income, after allowance of expenses, at ordinary rates. These are 32.5 percent for corporate income recipients and a range of zero to 65 percent for individuals. Under Articles 11 and 12, the tax so computed may not exceed 12.5 percent of the gross income, but it may be less, in which case a refund of the appropriate part of the tax withheld will be made.

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TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE KINGDOM OF MOROCCO FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME SIGNED AT RABAT AUGUST 1, 1977 AND RELATED EXCHANGES OF NOTES

The technical explanation is an official guide to the Convention. It reflects policies behind particular Convention provisions, as well as understandings reached with respect to the interpretation and application of the Convention.

Article 1. TAXES COVERED

Paragraph 1 designates the taxes of the Contracting States which are the subject of the Convention. In the case of the United States, the subject taxes are the Federal income taxes imposed by the Internal Revenue Code ("Code"). However, see paragraph 5 of Article 20 (General Rules of Taxation) with respect to the application of the personal holding company tax and accumulated earnings tax. The Convention does not apply to the estate, gift, and generation-skipping transfer taxes, the Windfall Profits Tax, Federal unemployment taxes, social security taxes or the excise taxes on premiums paid to foreign insurers. The covered taxes are referred to collectively in the treaty, and hereafter in this memorandum, as the "United States tax."

In the case of Morocco, paragraph 1 provides that the subject taxes are the agricultural tax; the taxes on urban property; the tax on public and private salaries, emoluments, fees, wages, pensions, and annuities; the complementary tax; the business profits tax; and the compulsory investment provided in Article 37 of Royal Decree No. 1.010-65 of the 8th Ramadan 1385 (December 31, 1965) containing the Finance Law for the year 1966. These taxes are referred to in the treaty, and hereafter in this memorandum, as the "Moroccan tax."

Under paragraph 2, the Convention will apply to any taxes substantially similar to those covered by paragraph 1 which are imposed in addition to, or in place of, existing taxes, after August 1, 1977 (the date of signature of the convention). For example, the temporary national solidarity tax introduced by Morocco in 1979, is covered by virtue of this paragraph.

Paragraph 3 provides that for the purpose of Article 22 (Nondiscrimination), the Convention will apply to taxes of every kind imposed at the national, state, or local level by either

Contracting State; and for the purposes of Article 26 (Exchange of Information), the Convention will apply to taxes of every kind imposed at the national level by either Contracting State.

Article 2. GENERAL DEFINITIONS

Paragraph 1 sets out definitions of certain basic terms used in the Convention. A number of important terms, however, are defined elsewhere in the Convention. For example, the terms "resident" and "permanent establishment" are defined in Articles 3 (Fiscal Residence) and 4 (Permanent Establishment), respectively.

The term "United States" means the United States of America. When used in a geographical sense, the term means the states of the United States, the District of Columbia, the territorial sea and, in general accord with the principles of section 638 of the Code, the continental shelf. The Convention does not apply to taxes payable to possessions of the United States or to the Commonwealth of Puerto Rico and confers no benefit on taxpayers by virtue of their residence in the possessions or in Puerto Rico.

The term "Morocco" means the Kingdom of Morocco, and when used in a geographical sense includes the territorial sea and, to the extent that exploration for or exploitation of natural resources takes place thereon, the continental shelf.

The term "Contracting State" means the United States or Morocco as the context requires.

The term "person" includes an individual, a partnership, a corporation, an estate, a trust, or any body of persons.

The term "United States corporation" or "corporation of the United States" is defined as a corporation which is created or organized under the laws of the United States, any state of the United States, or the District of Columbia, or any unincorporated entity treated as a corporation for United States tax purposes. The term "Moroccan corporation" or "corporation of Morocco" means any body corporate or any entity which is treated as a body corporate under Moroccan tax law and which is a resident of Morocco for Moroccan tax purposes. Morocco considers a corporation created or organized under the laws of Morocco as a Moroccan national, but a corporation created or organized outside Morocco can be a resident of Morocco for tax purposes if its seat of management is in Morocco.

With respect to the United States, the term "competent authority" means the Secretary of the Treasury or his delegate. With respect to Morocco, that term means the Minister in Charge of Finance or his delegate.

The term "State" means the United States, Morocco, or any other national state.

Paragraph 2 provides that in the application of any term used in the Convention which is not defined in the Convention, the term will, unless the context otherwise requires, be given the meaning which the term has under the laws of the Contracting State to the determination of whose tax the Convention is to be applied. However, in accordance with paragraph 2(d) of Article 25 (Mutual Agreement Procedure), the competent authorities may agree on a single meaning of any term used in the Convention. An agreement by the competent authorities with respect to the meaning of a term used in the Convention would supersede conflicting meanings in the domestic laws of the Contracting States.

Article 3. FISCAL RESIDENCE

This Article sets forth rules for determining the residence of individuals, corporations, and other persons for purposes of the Convention. The determination of the residence of an individual plays a central role in the application of the Convention because, in general, only persons who are residents of one of the Contracting States enjoy the benefits of the Convention. The Convention definition is, of course, exclusively for purposes of the Convention.

Paragraph 1 defines the term "resident of Morocco" as a Moroccan corporation (as defined in Article 2 (General Definitions)) and any person (except a corporation or an entity treated under Moroccan law as a corporation) resident in Morocco for purposes of its tax. Similarly, "resident of the United States" means a United States corporation (as defined in Article 2 (General Definitions)) and any person (except a corporation and any unincorporated entity treated as a corporation for United States tax purposes) resident in the United States for purposes of its tax. A resident of the United States includes a resident alien or an alien present in the United States who elects to be treated as a resident under Code section 6013(g) or (h). A citizen of the United States or Morocco is not automatically a resident of the country of his citizenship for purposes of this Convention. Residence for U.S. purposes is to be determined in accordance with the principles of the Treasury regulations under Code section 871.

A person acting as a partner or fiduciary is considered a resident of the United States only to the extent that the income derived by such person is subject to tax in the United States as the income of a resident. For example, under United States law, a partnership is never, and an estate or trust is often not, taxed on its income as such. Under the Convention, income received by a partnership, estate or trust will not be treated for purposes of the Convention as income derived by a resident of the United States unless such income is subject to tax by the United States as income of a resident. Thus, the treatment of income received by a partnership will be determined by the residence and taxation of its partners for United States tax purposes with respect to that income. To the extent the partners are subject to United States tax as residents of the United States, the partnership will be treated as a resident of the United States. Similarly, the treatment of income received by a trust or estate will be determined by the residence and taxation of the person subject to tax on the income. That person may be the grantor, the beneficiaries, or the trust or estate itself, depending on the character and terms of the trust.

Under paragraph 2, an individual who is a resident of both Contracting States under paragraph 1 will, for purposes of the Convention, be deemed to be a resident of that Contracting State in which he has his permanent home (the place at which an individual dwells with his family), his center of vital interests (closest personal and economic relations), a habitual abode, or his citizenship, in the order listed. If the issue is not settled by one of these tests, the competent authorities of the Contracting States are directed to decide by mutual agreement the state of which the individual is to be deemed a resident.

Under paragraph 3, an individual who is deemed to be a resident of one of the Contracting States and not a resident of the other Contracting States by reason of paragraph 2 will be deemed to be a resident only of the first-mentioned Contracting State for all purposes of the Convention, including Article 20 (General Rules of Taxation). For example, if an individual is determined to be a resident of Morocco under paragraph 2 and is also considered to be a resident of the United States under United States tax law, the Convention would require that the United States grant the individual the exemptions and special benefits the Convention requires the United States grant to residents of Morocco, unless the individual is a citizen of the United States. (See the saving clause of paragraph 3 of Article 20 (General Rules of Taxation)).

The Convention does not provide a rule for establishing a single residence of a corporation which is a dual resident of Morocco and the United States under the laws of the two countries. In such a case the taxpayer could request that the competent authorities attempt to resolve the issue by mutual agreement under Article 25 (Mutual Agreement Procedure) to avoid double taxation.

Article 4. PERMANENT ESTABLISHMENT

This Article defines the term "permanent establishment." The existence of a permanent establishment under Article 7 (Business Profits) determines the taxation of enterprises deriving industrial and commercial profits within the territory of each of the Contracting States.

Under paragraph 1, the term "permanent establishment" means a fixed place of business through which a resident of one of the Contracting States carries on industrial or commercial activity in the other Contracting State. Illustrations in paragraph 2 of a fixed place of business include a seat of management; a branch; an office; a factory; a workshop; a warehouse; a store or other sales outlet; a mine, quarry, or other place of extraction of natural resources; or a building site or construction or installation project which exists for more than six months. As a general rule, any fixed facility or premises through which a resident conducts industrial or commercial activity for an indefinite or substantial period of time will be treated as a permanent establishment unless the facility or premises are used only for one or more of the activities described in paragraph 3.

Under the construction or installation project rule, the six month period begins when work physically commences within the territory of the Contracting State. A series of contracts or projects which are interdependent both commercially and geographically are to be treated as a single project for the purpose of applying the six month test. If the six month period is exceeded, the site or project constitutes a permanent establishment from the first day.

Paragraph 3 specifically provides that a permanent establishment does not include a fixed place of business used only for one or more of a series of activities which are considered to be preparatory or auxiliary to industrial or commercial activity. The exceptions are cumulative and a fixed place of business used only for one or more of those purposes will not be considered a permanent establishment under the Convention.

Paragraph 4 provides that, notwithstanding the provisions of paragraphs 1, 2, and 3, a resident of one of the states who maintains substantial equipment for rental in the other Contracting State for a period of more than six months will be deemed to have a permanent establishment in the Contracting State in which the equipment is maintained. In such a case the rental income may be taxed by that State but only to the extent attributable to the permanent establishment and on a net basis in accordance with the rules of Article 7 (Business Profits).

Paragraph 5 provides that even if a resident of one of the Contracting States does not have a permanent establishment in the other Contracting State under paragraphs 1 through 4 of the Article, he shall nevertheless be deemed to have a permanent establishment in that other State if an agent has, and habitually exercises, in that State an authority to conclude contracts in the name of the resident, unless the exercise of the authority is limited to the purchase of goods and merchandise for that resident.

Paragraph 6 provides that a resident of one Contracting State will not be deemed to have a permanent establishment in the other Contracting State merely because he uses the services of a broker, general commission agent, or any other independent agent in the other Contracting State where the broker or agent acts for the resident in the ordinary course of the broker's own business.

Under paragraph 7 the fact that a resident of one Contracting State is a related person with respect to a resident of the other State or with respect to a person who engages in industrial or commercial activity in that other State (whether through a permanent establishment or otherwise) may not be taken into account in determining whether the resident of the first-mentioned Contracting State has a permanent establishment in that Contracting State. As defined in Article 9 (Related Persons), a person is related to another person if either person owns or controls directly or indirectly the other, or if any third person owns or controls directly or indirectly both such persons.

For purposes of the Convention, the provisions of this Article also apply in determining whether any person has a permanent establishment in any State. Thus, these principles would determine whether a resident of a third State has a permanent establishment in Morocco or the United States, in applying the Convention, and whether a resident of Morocco or the United States has a permanent establishment in a third State.

Article 5. SOURCE OF INCOME

This Article contains the rules which determine the source of income for purposes of the Convention. The Convention's general rules, set forth in Article 20 (General Rules of Taxation), restrict each Contracting State to taxing the income of residents of the other Contracting State only on income from sources within the first-mentioned State (provided that the resident is not a citizen of the first-mentioned State).

Paragraph 1 provides that dividends will be treated as income from sources within a Contracting State if and only if paid by a corporation of that State. Thus, dividends paid by a Moroccan corporation which would be of U.S. source under section 861(a)(2)(B) of the Internal Revenue Code are of Moroccan source under this provision.

Under paragraph 2, with two exceptions, interest is to be treated as income from sources within a Contracting State only if paid by that State, by a political subdivision or a local authority of that state, or by a resident of that State. Under the first exception, if the person paying the interest (whether or not such person is a resident of a Contracting State) has a permanent establishment in a Contracting State in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne as a deduction by the permanent establishment, the interest will be deemed to be from sources within the Contracting State in which the permanent establishment is situated. For example, assume that a resident of France has a permanent establishment in Morocco; the resident borrows money from a resident of the United States in connection with the permanent establishment; and the interest paid is borne as a deduction by the permanent establishment in Morocco. That interest will be deemed to have its source in Morocco and any Moroccan tax on such interest will be subject to the limitation in paragraph 2 of Article 11 (Interest). The principles of Article 4 (Permanent Establishment) are to be applied to determine whether a resident of a third country has a permanent establishment in Morocco.

Paragraph 2 also provides a second exception. If a resident of a Contracting State pays interest to a resident of the other Contracting State and if the indebtedness in respect of which the interest is paid was incurred in connection with a third country permanent establishment of that person paying the interest, and the interest is borne as a deduction by the permanent establishment, the interest will be deemed to be from sources within the state in which the permanent establishment is situated. This interest will be exempt from tax in a Contracting State where the payor is a resident if it is paid to a resident of the other Contracting State because, under Article 20 (General Rules of Taxation), a resident of one Contracting State, who is not a citizen of the other Contracting State, may be taxed by that other Contracting State only on income sources within that other State.

Paragraph 3 provides that royalties described in paragraph 3 of Article 12 (Royalties) may be treated as income from sources within a Contracting State only to the extent that the royalties are for the use of, or the right to use, the property or rights involved or for the performance of accessory services within that State; or if the royalties are paid for technical and economic studies described in paragraph 3(c) of Article 12.

Paragraph 4 provides that income from real property and royalties from the operation of mines, quarries, or other natural resources (including gains derived from the sale of such property or of the rights giving rise to such royalties) will be treated as income from sources within a Contracting State only if the property is situated in that State.

Paragraph 5 provides that income from the rental of tangible personal (movable) property will be treated as income from sources within a Contracting State only if the property is situated in that State.

Under paragraph 6, income received by an individual for his performance of labor or personal services, whether as an employee or in an independent capacity, will be treated as income from sources within a Contracting State only to the extent that the services are performed within that State. Income from personal services aboard ships or aircraft operated by a resident of a Contracting State in international traffic will be treated as income from sources within that State if rendered by a member of the regular complement of the ship or aircraft. For purposes of this paragraph, income from labor or personal services includes pensions, as defined in paragraph 3 of Article 19 (Private Pensions and Annuities), paid in respect of such services. However, remuneration described in Article 17 (Government Functions) is treated as income from sources within a Contracting State if and only if paid by or from the public funds of that State or of a political subdivision or local authority of that State.

Paragraph 7 provides that income from the purchase and sale of intangible or tangible personal (including movable) property (other than gains defined as royalties by paragraph 3(b) of Article 12 (Royalties)), shall be treated as income from sources within a Contracting State only if the property is sold in that State.

Paragraph 8 contains a general qualification of the preceding source rules. It provides that industrial or commercial profits attributable to a permanent establishment which the recipient, a resident of one Contracting State, has in the other Contracting State will be treated as income from sources within the State in which the permanent establishment is situated. Industrial or commercial profits attributable to such a permanent establishment may include any item of income described in paragraphs 1 through 6 if the item of income is "effectively connected" with the permanent establishment. See the discussion in paragraph 4(b) of Article 7 (Business Profits) for a discussion of the concept of "effectively connected" income.

Under paragraph 9, the source of any item of income to which paragraphs 1 through 8 are not applicable is to be determined by each Contracting State in accordance with its own law. However, if the source of any item of income under the laws of one Contracting State is different from its source under the laws of the other Contracting State, or if its source is not readily determinable under the laws of one of the Contracting States, the competent authorities of the Contracting States may, in order to prevent double taxation or further any other purpose of the Convention, establish a common source of the item of income for purposes of the Convention.

Several of the source rules set out in this Article differ to some degree from those existing in the Code. Since Article 20 (General Rules of Taxation) provides that the Convention will not increase a person's United States tax, a taxpayer is not required to apply the Convention rules in calculating his United States tax liability if the Code rules are more beneficial.

Article 6. INCOME FROM REAL PROPERTY

Under paragraph 1, income from real property, including royalties in respect of the natural resources and gains derived from the sale, exchange or other disposition of such property or of the rights giving rise to such royalties, may be taxed by the Contracting State in which the real property or natural resources are situated. However, income from real property does not include interest on indebtedness secured by real property (e.g., mortgages) or secured by a right giving rise to royalties in respect of the operation of mines quarries, or other natural resources. Such interest income is subject to the rules set forth by Article 11 (Interest).

Paragraph 1 applies to income derived from the usufruct, direct use, letting, or use in any other form of real property.

Article 7. BUSINESS PROFITS

Paragraph 1 sets forth the general rule that industrial or commercial profits, as defined in paragraph 4, of a resident of one Contracting State are exempt from tax by the other Contracting State unless the resident is engaged in industrial or commercial activity in the other State through a permanent establishment situated therein. Where the resident is so engaged, only the industrial or commercial profits attributable to the permanent establishment can be taxed by that other State, unless the resident is a citizen of that other State. (See the saving clause in paragraph 3 of Article 20 (General Rules of Taxation)).

Under paragraph 8 of Article 5 (Source of Income), industrial or commercial profits attributable to a permanent establishment which a resident of one Contracting State has in the other Contracting State will be considered to be from sources within that other State. Under this rule, items of income described in section 864(c)(4)(B) of the Code attributable to a permanent establishment situated in the United States will be subject to tax by the United States.

In determining the proper attribution of industrial or commercial profits under the Convention, paragraph 2 provides that both Contracting States will attribute to a permanent establishment the profits which the establishment would have earned had it been an independent entity engaged in the same or similar activities under the same or similar conditions dealing wholly independently with the resident of which it is a permanent establishment.

Under paragraph 3, expenses reasonably connected to profits attributable to the permanent establishment, including costs and general expenses related to services rendered for the benefit of the permanent establishment, whether incurred in the Contracting State in which the permanent establishment is situated or elsewhere, will be allowed as deductions in determining the industrial or commercial profits of the permanent establishment.

Paragraph 4(a) defines the term "industrial or commercial profits." It includes income from insurance and from the rental of personal property, except that film rentals are covered under Article 12 (Royalties). Accordingly, rentals of other personal property derived by a resident of one Contracting State may be taxed by the other Contracting State only to the extent attributable to a permanent establishment. Paragraph 4 of Article 4 (Permanent Establishment) provides that maintaining substantial equipment for rental for more than 6 months constitutes a permanent establishment. Profits may also include income derived from real property and natural resources, dividends, interest, royalties (as defined in Article 12 (Royalties)), and capital gains but only if the property or rights giving rise to such income, dividends, interest, royalties, or capital gains is effectively connected with a permanent establishment which the recipient, being a resident of one Contracting State, has in the other Contracting State, whether or not the income such property gives rise to is itself derived from industrial or commercial activity. See paragraph 3 of Article 10 (Dividends), paragraph 3 of Article 11 (Interest), paragraph 4 of Article 12 (Royalties). and paragraph 1(b) of Article 13 (Capital Gains). It does not include employment income of employees or self-employed persons.

Paragraph 4(b) contains criteria for determining whether property or rights are effectively connected with a permanent establishment. Factors to be taken into account include whether the rights or property are used in or held for use in carrying on industrial or commercial activity through a permanent establishment and whether the activities carried on through such permanent establishment are a material factor in the realization of the income derived from such property or rights. For this purpose, due regard is to be given to whether or not such property or rights or such income were accounted for through such permanent establishment. The effectively connected test established by this paragraph is substantially similar to the effectively connected test in section 864(c) of the Code.

Under paragraph 5, where industrial or commercial profits include items which are dealt with separately in other articles of the Convention, the provisions of those articles will, except as otherwise provided therein, supersede the provisions of this article. Thus, for example, taxation of interest income will be controlled by Article 11 (Interest) and not by this article unless, as provided by paragraph 3 of Article 11, the interest is effectively connected with a permanent establishment.

Article 8. SHIPPING AND AIR TRANSPORT

Paragraph 1 provides that, notwithstanding Article 7 (Business Profits) and Article 13 (Capital Gains), income and gains derived by a resident of one of the Contracting States from the operation in international traffic of ships registered in that State, or from the disposition of such ships, will be exempt from tax by the other Contracting State.

Paragraph 2 provides that, notwithstanding Article 7 (Business Profits) and Article 13 (Capital Gains), income and gains derived by a resident of one of the Contracting States from the operation in international traffic of aircraft registered in either Contracting State, or in any State with which the other Contracting State has an income tax treaty exempting such income, or from the disposition of such aircraft, shall be exempt from taxation in the other Contracting State. For example, a U.S. resident would be exempt from tax by Morocco on income from the international operation of aircraft registered in the United States or in any country with which Morocco has a treaty providing exemption of income from the international operation of aircraft registered in that country.

Article 9. RELATED PERSONS

This article complements section 482 of the Code and confirms the authority of the United States to apply that section to transactions between United States persons and residents of

Morocco. Under paragraph 1, where a resident of one of the Contracting States and a resident at the other Contracting State are related and where those related persons make arrangements or impose conditions between themselves which are different from those which would be made between independent persons, any income, deductions, credits or allowances which would, but for those arrangements or conditions, have been taken into account in computing the income or loss of, or the tax payable by, one of such persons, may be taken into account in computing the amount of the income subject to tax and the taxes payable by the person.

It is anticipated that if a Contracting State makes an adjustment in accordance with paragraph 1 to the income of one of its residents, the other Contracting State will, if it accedes to the propriety of the redetermination and if it is necessary to prevent double taxation, make a corresponding adjustment to the income of the related person resident in the other Contracting State. If the other Contracting State disputes the propriety of the redetermination, it is intended that the two Contracting States will endeavor to reach agreement in accordance with the mutual agreement procedure in Article 25 (Mutual Agreement Procedure).

Paragraph 2 provides that for purposes of the Convention a person is related to another person if either owns or controls directly or indirectly the other, or if a third person or persons own or control both directly or indirectly. "Control" includes any kind of control, whether or not legally enforceable, and however exercised or exercisable.

Article 10. DIVIDENDS

Paragraph 1 provides that dividends derived from sources within one Contracting State by a resident of the other Contracting State may be taxed by both States.

Paragraph 2, however, limits the rate of tax imposed by the first-mentioned Contracting State to a rate not in excess of 15 percent of the gross amount actually distributed, or 10 percent of the gross amount actually distributed in the case of certain dividends paid by a subsidiary to its parent corporation. The 10 percent rate applies if the dividend recipient is a corporation which (a) owned at least ten percent of the outstanding shares of the voting stock of the paying corporation during the part of the paying corporation's taxable year which precedes the date of payment of the dividend and during the whole of its prior taxable year (if any), and (b) not more than twenty-five percent of the gross income of the paying corporation for such prior taxable year (if any) consisted of interest or dividends other than interest derived from the conduct of a banking, insurance, or financing business and other than interest or dividends from subsidiary corporations of which the paying corporation owned fifty percent or more of the outstanding shares of the voting stock at the time such dividends or interest were received. The 10 percent rate also applies to profits of Moroccan branches and establishments available for remittance to their U.S. home offices, as confirmed in an exchange of notes of April 17, 1981.

These rate limitations do not affect the taxation of profits of the corporation which pays the dividends.

Paragraph 3 provides that the limitations of paragraph 2 will not apply if the dividend recipient, being a resident of one Contracting State, has a permanent establishment in the other Contracting State and the shares with respect to which the dividends are paid are effectively connected with the permanent establishment. In such a case, the dividends are attributable to the permanent establishment and are treated as industrial or commercial profits subject to Article 7 (Business Profits). If the dividend recipient is a citizen of the source Contracting State, that Contracting State may tax the recipient without regard to this article because of the saving clause of paragraph 3 of Article 20 (General Rules of Taxation).

Paragraph 4 provides that dividends paid by a corporation of one of the Contracting States to a person other than a resident of the other Contracting States, or, in the case of a payment by a Moroccan corporation, to a person who is neither a resident nor a citizen of the United States, shall be exempt from tax by the other Contracting State. This paragraph does not apply if the recipient of the dividends has a permanent establishment in the other Contracting State and the shares with respect to which the dividends are paid are effectively connected, within the meaning of paragraph 4(b) of Article 7, with the recipient's permanent establishment.

Article 11. INTEREST

Paragraph 1 provides that interest derived from sources within one Contracting State by a resident of the other Contracting State may be taxed by both States.

Paragraph 2, however, limits the tax imposed by the first-mentioned Contracting State to a rate not in excess of 15 percent. Paragraph 6 provides an exemption for interest paid to certain Government instrumentalities.

This article is subject to the saving clause of paragraph 3 of Article 20 (General Rules of Taxation). Therefore, interest derived by a citizen of the source Contracting State may be taxed by that Contracting State without regard to this article.

Paragraph 3 provides that paragraph 2 will not apply if the recipient, being a resident of one Contracting State, has a permanent establishment in the other Contracting State and the indebtedness giving rise to the interest is effectively connected with the permanent establishment. In such a case, the interest is attributable to the permanent establishment and will be treated as industrial or commercial profits of the permanent establishment subject to Article 7 (Business Profits).

Paragraph 4 defines the term "interest" for purposes of the Convention as income from bonds, Government securities, or debentures, whether or not secured by mortgage and whether or not carrying a right to participate in profits, and debt-claims of every kind, as well as all other income which, under the taxation law of the Contracting State in which the income has its source, is assimilated to income from money lent.

Paragraph 5 provides that if excessive interest payments are made between related persons, the provisions of the article will apply only to the amount which would have been agreed upon in the absence of the relationship. The excess part of the payment shall remain taxable according to the laws of each of the Contracting States, due regard being given to the other provisions of the Convention.

Paragraph 6 provides that interest received by one of the Contracting States itself, or by an instrumentality of that State which is not subject to income tax by such State, such as the U.S. Export-Import Bank and the Overseas Private Investment Corporation, shall be exempt from tax by the State of source.

Article 12. ROYALTIES

Paragraph 1 provides that royalties derived from sources within one Contracting State by a resident of the other Contracting State may be taxed by both States.

Paragraph 2, however, limits the tax imposed by the first-mentioned State to a rate not in excess of 10 percent.

This article is subject to the saving clause of paragraph 3 of Article 20 (General Rules of Taxation). Therefore, royalties derived by a citizen of a Contracting State may be taxed by that State without regard to this Article.

Paragraph 3 defines the term "royalties" as payment of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, or scientific works, copyrights of motion picture films or films or tapes used for radio or television broadcasting, patents, designs, models, plans, secret processes or formulas, trademarks, or other like property or rights, or knowledge, experience, or skill (know-how), including the performance of accessory technical assistance for the use of such property or rights to the extent that the assistance is provided in the State where the payment has its source. The term also includes gains derived from the sale, exchange, or other disposition of any such property or rights to the extent the amounts realized on such sale, exchange or other disposition for consideration are contingent on the productivity, use, or disposition of the property or rights. If the amounts realized are not so contingent, the provisions of Article 13 (Capital Gains) will apply. In addition, payments for technical and economic studies made from the public funds of the Moroccan Government in the discharge of functions of a governmental nature by the Moroccan Government or by a political subdivision or local authority thereof are defined as royalties and therefore may be taxed by Morocco under paragraph 2 of this article instead of as profits under Article 7 (Business Profits). The term "royalties" as used in the Convention does not include any royalties, rentals or other amounts paid in respect of the operation of mines, quarries, or other natural resources, which are covered by Article 6 (Income from Real Property).

Paragraph 4 provides that paragraph 2 will not apply if the royalty recipient, being a resident of one Contracting State, has in the other Contracting State a permanent establishment and the property or rights giving rise to the royalty is effectively connected with the permanent establishment. In such a case, the royalty will be attributable to the permanent establishment and will be treated as industrial or commercial profits subject to Article 7 (Business Profits).

If excessive royalties are paid to a related person, paragraph 5 provides that the provisions of the article do not apply to the excessive portion of the royalty. The excessive portion may be taxed by each Contracting State according to its own law, including the Convention where applicable. For example, the excessive portion may be treated as a dividend or interest, or in whatever other manner is appropriate according to the law of the State of source.

As noted under paragraph 3 of Article 6 (Source of Income), royalties described in paragraph 3, including contingent gains, will be treated as income from sources within a Contracting State only to the extent they are payments for the use of, or the right to use, property or rights described in paragraph 3 within that Contracting State.

Article 13. CAPITAL GAINS

Under paragraph 1, a resident of one of the Contracting States is taxable on gains from the sale or exchange of capital assets only in the State of which he is a resident. There are, however, three circumstances in which a resident of one of the Contracting States will be taxable in the other Contracting State. These are set forth in paragraph 2.

Under paragraph 2(a), the gain realized by a resident of one of the Contracting States from the sale or exchange of property described in Article 6 (Income from Real Property) located within the other Contracting State, or from the disposition of shares or comparable interests in a corporation or cooperative whose assets consist principally of such property, is taxable in the Contracting State in which the property is situated.

Under paragraph 2(b), if the recipient of the gain is a resident of one Contracting State who has a permanent establishment in the other Contracting State, and if the gain is effectively connected with the permanent establishment, then the gain may be taxed by the State in which the permanent establishment is situated. See paragraph 4(b) of Article 7 for a discussion of what constitutes income "effectively connected" with a permanent establishment. Under paragraph 3, the provisions of Article 7 apply to gains described in paragraph 2(b).

Under paragraph 2(c), if an individual resident of one of the Contracting States maintains a fixed base in the other Contracting State and the gain is effectively connected with that fixed base, or if the individual is present in that other State for a period or periods exceeding in the aggregate 183 days during a taxable year, the gain is taxable by that other State. The term "day" for purposes of the physical presence tests contained in the Convention with respect to an individual means a calendar day during any portion of which the individual is physically present in the relevant Contracting State.

Article 14. INDEPENDENT PERSONAL SERVICES

In dealing with the taxation of income from personal services, the Convention distinguishes between "independent" and "dependent" personal services.

Under paragraph 1 of this article, income derived by an individual resident of one Contracting State from the performance of personal services in an independent capacity may be taxed by that Contracting State. Except as provided in paragraph 2 (or in the "saving" clause of paragraph 3 of Article 20), such income will be exempt from tax by the other Contracting State.

Under paragraph 2, income derived from performing independent personal services in the other Contracting State may be taxed by that other Contracting State if any of three conditions is met: (1) the individual is present therein for a period or periods aggregating 183 days or more in the taxable year; or (2) the individual maintains a fixed base therein for a period or periods aggregating 90 days or more in the taxable year (but only on the income attributable to the fixed base); or (3) the gross amount of such income exceeds $5,000 or its equivalent in Moroccan dirhams for the year. The term "fixed base" is not defined but is intended to be analogous to a "permanent establishment" (see Article 4).

Paragraph 3 defines "personal services in an independent capacity" to mean all activities - other than commercial, industrial, or agricultural activities - performed by an individual for his own account where he receives the income and bears the losses arising from such services. If an individual is an independent contractor he is considered as rendering independent personal services. Generally, services rendered by physicians, lawyers, engineers, architects, dentists and accountants performing personal services as sole proprietors or partners are independent personal services. Commercial, industrial or agricultural activities carried on by a sole proprietor are covered by Article 7 (Business Profits).

Article 15. DEPENDENT PERSONAL SERVICES

Paragraph 1 provides that wages, salaries, and similar remuneration derived by an individual who is a resident of one Contracting State from labor or personal services performed as an employee may be taxed by that State and, if for services performed in the other State, may also be taxed by that other State subject to the exceptions in paragraph 2 and to the provisions of Articles 17 (Government Functions) and 18 (Students and Trainees). The term "wages, salaries and similar remuneration" includes income for services performed as an officer of a corporation, but not income for services as a member of the board of directors; the latter is covered under Article 14 (Independent Personal Services).

Under paragraph 2, such remuneration derived by an individual resident of one Contracting State will be exempt from tax by the other Contracting State if three conditions are met: (a) the individual is present in the other State for a period or periods aggregating less than 183 days in the taxable year; (b) the individual is an employee of a resident of the first-mentioned Contracting State or of a permanent establishment maintained in the first-mentioned Contracting State by a resident of a State other than that first-mentioned State; and (c) the remuneration is not borne as a deduction by a permanent establishment which the employer has in the other Contracting State. Such income may nevertheless be taxed by the other Contracting State if the individual is a citizen of that Contracting State, because of paragraph 3 of Article 20 (General Rules of Taxation).

Paragraph 3 provides a special rule, which overrides paragraph 2, that remuneration derived by an individual for performing personal services as an employee aboard ships or aircraft operated by a resident of a Contracting State in international traffic will be exempt from tax by the other Contracting State if such individual (even if a resident of a State other than a Contracting State) is a member of the regular complement of the ship or aircraft. However, this paragraph is also subject to the saving clause of paragraph 3 of Article 20 (General Rules of Taxation) so that the other Contracting State may tax a citizen or resident of that State without regard to this paragraph.

Article 16. ARTISTES AND ATHLETES

Notwithstanding the provisions of Articles 14 (Independent Personal Services) and 15 (Dependent Personal Services), the remuneration of professional entertainers and athletes may be taxed by the Contracting State where the services are performed without any threshold period of time spent in that State or amount of income received for the services performed there.

However, paragraph 3 provides an exception for nonprofit organizations and their members (unless the members are acting on their own account). Thus, income from services performed in Morocco by a U.S. orchestra, ballet or theater group which qualifies as a nonprofit organization under section 501(c)(3) of the Internal Revenue Code would not be taxable by Morocco under this Article but under the provisions of Articles 14 (Independent Personal Services) or 15 (Dependent Personal Services) as appropriate.

Paragraph 2 provides that when income from the performing personal services by an entertainer or athlete is attributed to another person, that income may be taxed by the Contracting State where the services are performed without regard to the threshold conditions provided in Articles 7 (Business Profits), 14 (Independent Personal Services) and 15 (Dependent Personal Services). Although worded more broadly, this provision is intended to reach abuse situations where the personal service income of an entertainer or athlete is diverted to another person to avoid tax. The drafting and interpretation are consistent with that of the OECD Model of January 1977 (see Article 17 and paragraph 4 of the commentary on that article).

Article 17. GOVERNMENTAL FUNCTIONS

Under this article remuneration, including pensions or similar benefits, paid by or from public funds of a Contracting State to an employee who is a citizen of that State for personal services performed in the discharge of governmental functions for that State or a political subdivision will be exempt from tax by the other Contracting State. The exemption does not extend to income for services of a commercial nature. The determination of what functions are governmental in nature may be made by comparison with the concept of a governmental function in the State where the income arises. Nor does it extend to employees of a Contracting State who are citizens of the other State or of a third State. If the individual becomes a citizen of, or acquires immigrant status in, the other Contracting State, that other State may tax the individual without regard to this article. See paragraphs 3 and 4 of Article 20 (General Rules of Taxation).

Article 18. STUDENTS AND TRAINEES

This article provides an exemption from tax by a Contracting State of certain income of visiting students and trainees from the other Contracting State. Paragraph 1(a) specifies the conditions under which an individual may claim the benefits of the Article and paragraph 1(b) specifies the exempt amounts.

This article applies to an individual who is a resident of one Contracting States at the time he becomes temporarily present in the other Contracting State and whose primary purpose for going to the other State is to study at a university or other recognized educational institution in that other State, or to secure training required to qualify him to practice a profession or professional speciality, or to study or do research as a recipient of a grant, allowance, or award from a governmental, religious, charitable, scientific, literary, or educational organization. Such an individual may be exempt from tax by that other State for a period not exceeding five taxable years from the date of his arrival in that State on:

(1) Gifts from abroad for the purpose of his maintenance, education, study, research or training;

(2) The grant, allowance, or award; and

(3) Income from personal services performed in the other Contracting State not in excess of $2,000 or its equivalent in Moroccan dirhams for any taxable year.

These exemptions are in addition to the amounts allowed by statute as personal exemptions or allowable itemized deductions. A nonresident alien is only allowed one personal exemption and may not take advantage of the zero bracket amount.

The benefits conferred by the host state under this article are not subject to the saving clause of paragraph 3 of Article 20 (General Rules of Taxation), with respect to individuals who are neither citizens of, nor have immigrant status in, that State. In other cases, the saving clause does apply.

Article 19. PRIVATE PENSIONS AND ANNUITIES

Except as provided in Article 17 (Governmental Functions), pensions and other similar remuneration paid to an individual who is a resident of a Contracting State in consideration of past employment are taxable only by that State. Thus, private pensions and similar remuneration derived from sources within one Contracting State by an individual resident of the other Contracting State in consideration of past employment are exempt from tax by the first-mentioned State.

Similarly, paragraph 2 provides that alimony and annuities paid to an individual resident of a Contracting State are taxable only by that State.

The term "pensions and other similar remuneration" is defined in paragraph 3 as periodic payments made after retirement or death in consideration for services rendered, or by way of compensation for injuries received in connection with past employment. It does not include social security payments. Morocco may, therefore, tax residents of Morocco on their U.S. social security benefits (subject to a credit under Article 21 (Relief from Double Taxation) if there were a U.S. tax at source on such payments).

The term "annuities" is defined in paragraph 4 as a stated sum paid periodically at stated times during life or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than for services rendered).

The term "alimony" is defined in paragraph 5 as periodic payments made pursuant to a decree of divorce, separate maintenance agreement, or support or separation agreement which is taxable to the recipient under the internal laws of the Contracting State of which he is a resident. A payment which would not be taxable to the recipient under the laws of the Contracting State in which the recipient is a resident would not be treated as alimony for purposes of this article, and therefore would be taxable at source in accordance with the laws of the Contracting States and in accordance with paragraph 1 of Article 20 (General Rules of Taxation).

The Article does not apply to child support payments, which are therefore taxable at source in accordance with paragraph 1 of Article 20 (General Rules of Taxation).

This article is subject to the "saving" clause of paragraph 3 of Article 20 (General Rules of Taxation). Therefore, individuals who are citizens of a Contracting State may be taxed by that Contracting State without regard to this article.

Article 20. GENERAL RULES OF TAXATION

Under paragraph 1, a resident of one Contracting State may be taxed by the other Contracting State on any income from sources within that other Contracting State and only on such income, subject to any limitations set forth in the Convention. For this purpose, the source of income is determined according to the rules contained in Article 5 (Source of Income).

Paragraph 2 contains the customary rule that the Convention will not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded by the laws of a Contracting State in the determination of a tax imposed by it, or by any other agreement between the Contracting States. This rule reflects the principle that a convention should not increase the tax burden on residents of the Contracting States. Thus, a Contracting State may not impose tax solely by virtue of the Convention if it does not impose a tax, in such cases, under its domestic law. Paragraph 2 does not, however, authorize a taxpayer to make inconsistent choices between rules of the Code and rules of the Convention. In no event are the rules of the Convention to increase overall U.S. tax liability above what liability would be if there were no Convention.

Paragraph 3 contains the traditional "saving" clause under which the United States reserves the right to tax its citizens and residents (as determined under Article 3 (Fiscal Residence)) as if the Convention had not come into effect. However, under paragraph 4, the saving clause does not apply in several cases in which its application would contravene policies reflected in the Convention. Thus, the saving clause does not affect the provisions with respect to relief from double taxation, nondiscrimination, or the mutual agreement procedure. Moreover, the saving clause does not affect the benefits conferred by the Convention on students and trainees, and on individuals performing governmental functions, who are neither citizens of, nor have immigrant status in, the Contracting State imposing the tax. In the case of the United States, "immigrant status" means the status of having been admitted to the United States for permanent residence.

Paragraph 5 reserves the right of the United States to impose its personal holding company tax (section 541 of the Code) and its accumulated earnings tax (section 531 of the Code) notwithstanding any provision of the Convention. However, a Moroccan corporation will be exempt from the personal holding company tax in any taxable year if all of its stock is owned by one or more individuals who are residents of Morocco for that entire year. In addition, a Moroccan corporation will be exempt from the accumulated earnings tax in any taxable year unless it is engaged in trade or business in the United States through a permanent establishment at any time during such year.

Paragraph 6 authorizes the competent authorities of the Contracting States to prescribe regulations necessary to carry out the provisions of the Convention. On the United States side, this authority exists under section 7805 of the Code.

Paragraph 7 provides that where, pursuant to any provision of the Convention, a Contracting State is required to reduce its rate of tax on, or to exempt, income of a resident of the other Contracting State, and where, under the law in force in that other State, the resident is subject to tax only upon income remitted to or received in that State, then the required rate reduction of exemption shall apply only with respect to the income subject to taxation in that State.

Article 21. RELIEF FROM DOUBLE TAXATION

Under paragraph 1, the United States agrees to allow a United States citizen or resident as a credit against the United States income tax the appropriate amount of income taxes paid to Morocco. The Moroccan taxes covered in paragraphs 1(b) and 2 of Article 1 (Taxes Covered) are considered creditable income taxes for this purpose. The appropriate amount is based upon the amount actually paid to Morocco, but is not to exceed the portion of United States tax which the citizen's or resident's net income from sources within Morocco bears to his entire net income for the taxable year. As long as the Internal Revenue Code authorizes an overall limitation on the foreign tax credit the taxpayer may elect that limitation if it is more beneficial. However, if the taxpayer chooses the treaty credit for an otherwise non-creditable payment (e.g., the compulsory investment in equipment bonds) he must use the per-country limitation provided by the Convention.

Paragraph 2 provides that for purposes of computing the appropriate amount of taxes paid to Morocco, a citizen or resident of the United States who receives income or dividends from Morocco may elect to include in the computation of Moroccan taxes paid the amount the citizen or resident was required to invest in Moroccan equipment bonds under Article 37 of the Royal Decree No. 1.010-65 of the 8th of Ramadan 1385 (December 31, 1965) containing the Finance Law for the year 1966. The amount required to be invested in such bonds is generally 50 percent for industrial companies and 80 percent for other companies (e.g., services and trade) of 8 percent of taxable income for purposes of the corporate income tax and the urban property tax; i.e., 4 percent or 6.4 percent of taxable income. That amount must be invested in nonnegotiable 10 year bonds which pay interest at 5 percent. The Article provides that, in order to include these amounts, the citizen or resident must agree that any repayment by the Moroccan Government of such bonds would be treated as a refund of Moroccan taxes for the year of repayment. An exchange of notes of October 25, 1979 confirms that, with respect to a U.S. taxpayer who elects to include an amount invested in Moroccan equipment bonds in his Moroccan tax for which foreign tax credit is claimed, interest paid on the bonds net of any Moroccan tax on such interest will belong to the U.S. Government, in accordance with section 905(c) of the Internal Revenue Code. The Treasury Department will issue regulations implementing this provision.

Under paragraph 3, Morocco will allow a citizen or resident of Morocco a credit against Moroccan income tax the appropriate amount of income taxes paid to the United States. This appropriate amount is to be based upon the amount of tax paid to the United States but is not to exceed the portion of the Moroccan tax which the citizen's or resident's net income from sources within the United States bears to his entire net income for the taxable year.

Article 22. NONDISCRIMINATION

Paragraph 1 provides that a citizen of one Contracting State who is a resident of the other Contracting State will not be subjected in that other Contracting State to more burdensome taxes than a citizen of that other Contracting State who is a resident thereof. The determination whether there is more burdensome taxation is to be made by comparing the treatment of individuals who are in comparable positions. Thus, for example, a citizen of Morocco who is a resident of the United States and who otherwise meets the requirements specified in section 911 of the Code would under this article be eligible for the benefits of section 911 even though not a citizen of the United States.

Paragraph 2 provides that a permanent establishment which a resident of one Contracting State has in the other Contracting State will not be subject in that other Contracting State to more burdensome taxes than a resident of that other Contracting State carrying on the same activities. However, this does not obligate a Contracting State to grant to individual residents of the other Contracting State any personal allowances, reliefs, or deductions for taxation purposes on account of civil status or family responsibilities which it grants to its own individual residents.

Paragraph 3 prohibits a Contracting State from subjecting to more burdensome taxation or related requirements a corporation of that State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by residents of the other

Contracting State to any taxation or any requirement connected with taxation which is other or more burdensome than those applicable to corporations of the first-mentioned State carrying on the same activities, the capital of which are wholly or partly owned or controlled by one or more residents of the first-mentioned Contracting State.

The provisions of this Article do not override the right of the United States to impose the tax provided in Code section 897 (relating to gains derived by nonresident aliens or foreign corporations from U.S. real property interests.)

Article 23. DIPLOMATIC AND CONSULAR OFFICERS

This article provides that nothing in the Convention will affect the fiscal privileges of diplomatic and consular officials under the general rules of international law or under the provisions of special agreements. This is merely a special case of the general rule provided in paragraph 2 of Article 20 (General Rules of Taxation).

Article 24. INVESTMENT OR HOLDING COMPANIES

This article provides that a corporation of one Contracting State deriving dividends, interest, royalties or capital gains from sources within the other State will not be entitled to the benefits of Articles 10 (Dividends), 11 (Interest), 12 (Royalties) or 13 (Capital Gains) if, by reason of special measures, the tax imposed on such corporation by the first-mentioned Contracting State with respect to such dividends, interest, royalties or capital gains is substantially less than the tax generally imposed by such Contracting State on corporate profits, and twenty-five percent or more of the capital of such corporation is held of record or is otherwise determined, after consultation between the competent authorities of the Contracting States, to be owned, directly or indirectly, by one or more persons who are not individual residents of the first-mentioned Contracting State (or, in the case of a Moroccan corporation, who are not citizens of the United States). For purposes of applying this article it is intended that the requisite direct or indirect ownership be tested at the individual shareholder level.

The purpose of this article is to deal with potential abuse which could occur if one of the Contracting States provided preferential rates of tax for investment or holding companies. In such a case, in the absence of this Article, residents of third countries could organize a corporation in that Contracting State for the purpose of making investments in the other Contracting State and realize unintended benefits of treaty rate reductions. Existing Code rules with respect to the taxation of capital gains do not make this provision applicable with respect to capital gains.

Article 25. MUTUAL AGREEMENT PROCEDURE

When a resident of one Contracting State considers that the action of one or both Contracting States results, or will result, for him in taxation not in accordance with the Convention, he may, notwithstanding the remedies provided by the national laws of the Contracting States, present his case to the competent authority of the State of which he is a resident. If the claim is considered to have merit by the competent authority, that competent authority must endeavor to come to an agreement with the competent authority of the other Contracting State to avoid taxation contrary to the Convention.

Paragraph 2 requires the competent authorities of the two Contracting States to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the application of the Convention. In particular, the competent authorities may agree to the same attribution of industrial or commercial profits to a resident of one Contracting State and its permanent establishment situated in the other Contracting State; the same allocation of income, deductions, credits, or allowances between a resident of one Contracting State and any related person; the same determination of the source of particular items of income; and the same meaning of any term used in this Convention.

Under paragraph 3, the competent authorities may communicate with each other directly and, when advisable, meet together for an oral exchange of opinions for the purpose of reaching an agreement.

Under paragraph 4, in cases in which the competent authorities reach an agreement, taxes will be imposed on such income, and refund or credit of taxes allowed, by the Contracting States in accordance with such agreement. This permits the issuance of a refund or credit notwithstanding procedural barriers otherwise existing under a Contracting State's law, such as the statute of limitations. This result is confirmed in the exchange of notes of October 25, 1979.

Article 26. EXCHANGE OF INFORMATION

Paragraph 1 provides for a system of administrative cooperation between the competent authorities of the two Contracting States by requiring an exchange of information pertinent to carrying out the provisions of the Convention and of the domestic laws of the Contracting States concerning taxes covered by the Convention. Any information so exchanged is required to be treated as secret, and may not be disclosed to persons other than those (including a court or administrative body) concerned with assessment, collection, enforcement, or prosecution in respect of the taxes which are the subject of the Convention.

Under paragraph 2, paragraph 1 is not to be construed so as to impose upon one of the Contracting States the obligation to carry out administrative measures at variance with its own laws or administrative practice; to supply particulars which are not obtainable under the laws, or in the normal course of the administration of that Contracting State or of the other Contracting State; or to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information, the disclosure of which would be contrary to public policy.

Under paragraph 3, the exchange of information may be on either a routine basis or on request with reference to particular cases. The competent authorities may agree on a list of items of information to be furnished on a routine basis. For example, information on tax withheld at the source on payments to recipients in the other Contracting State may be routinely furnished to that State. The Article authorizes a Contracting State to obtain information for the other State, even if there is no tax liability in the State which is requested to obtain the information.

Paragraphs 4 and 5 provide that the competent authorities will transmit to each other at least once a year amendments to the tax laws referred to in paragraph 1 of Article 1 (Taxes Covered), adopted taxes referred to in paragraph 2 to that article, or published material concerning application of the Convention, whether in the form of regulations, rulings or judicial decisions.

Under paragraph 3 of Article 1 (Taxes Covered), the provisions of this article extend to taxes of every kind imposed at the national level. For example, they would apply on the U.S. side to the Federal estate and gift tax provisions.

Article 27. EXTENSION TO TERRITORIES

Under paragraph 1, either Contracting State may, at any time while the Convention continues in force, by a written notification given to the other Contracting State through diplomatic channels, declare its desire that the Convention, either in whole or in part or with such modifications as may be found necessary for special application in a particular case, shall extend to all or any of the areas (to which the Convention is not otherwise applicable) for whose international relations it is responsible and which impose taxes substantially similar in character to those which are the subject of the Convention. When the other Contracting State has, by a written communication through diplomatic channels, signified to the first-mentioned Contracting State that such notification is accepted in respect of such area or areas, and the notification and communication have been ratified and instruments of ratification exchanged, the Convention, in whole or in part, or with such modifications as may be found necessary for special application in a particular case, as specified in the notification, will apply to the area or areas named in the notification and will enter into force and effect on and after the date or dates specified therein. None of the provisions of the Convention will apply to any such area in the absence of such acceptance and exchange of instruments of ratification in respect of that area.

Under paragraph 2, at any time after the date of entry into force of an extension under paragraph 1, either Contracting State may, by six months' prior notice of termination given to the other Contracting State through diplomatic channels, terminate the application of the Convention to any area to which it has been extended under paragraph 1. In such event the Convention will cease to apply and have force and effect, beginning on or after the first day of January next following the expiration of the six-month period, to the area or areas named therein, but without affecting its continued application to the United States, Morocco, or to any other area to which it has been extended under paragraph 1.

Pursuant to paragraph 3, in the application of the Convention in relation to any area to which it is extended by notificiation by Morocco or the United States, reference to "Morocco" or the "United States", as the case may be, shall be construed as referring to that area.

Under paragraph 4, termination in respect of the United States or Morocco of the Convention under Article 29 (Termination) will unless otherwise expressly agreed by both Contracting States, terminate the application of the Convention to any area to which the Convention has been extended under this article by the United States or Morocco.

Article 28. ENTRY INTO FORCE

Under paragraph 1, the Convention is to be ratified and instruments of ratification are to be exchanged as soon as possible after ratification at Washington, D.C.

Under paragraph 2, the Convention will enter into force upon the exchange of instruments of ratification, and will apply to taxes due at the source on income payable or paid on and after the first day of the month following the exchange of instruments of ratification, and to all other taxes for taxable years beginning on or after the first day of January of the year of ratification.

Article 29. TERMINATION

This article provides that the Convention will remain in force indefinitely, but that it may be terminated by either Contracting State at any time after five years from the date on which the Convention enters into force. In order to terminate the Convention, a Contracting State must notify the other Contracting State in writing submitted through diplomatic channels of its intention to terminate the Convention before June 30th of any calendar year. In the event a Contracting State so notifies the other Contracting State, the Convention will apply for the last time to taxes due at the source on income payable or paid not later than December 31 of the year in which termination occurs, and to other taxes imposed on income for taxable periods ending not later than December 31 of the year in which termination occurs.

EXCHANGES OF NOTES

A note accompanying the convention and signed at the same time expresses the concern of the Moroccan Government at the absence in the convention of a "tax sparing" credit by the United States and an agreement by the United States to resume discussions on this point if the Senate approves such a provision for another country.

An exchange of notes signed on October 25, 1979 by Mr. Alaoui Medaghri, Director of the Tax Division of the Ministry of Finance of Morocco and Mr. Donald Lubick, then Assistant Secretary for Tax Policy of the U.S. Treasury clarifies the treatment of interest paid on Moroccan equipment bonds under Article 21(2) and states that solutions to claims of double taxation reached under the mutual agreement procedure in accordance with Article 25(1) will be implemented notwithstanding statutory time limits.

A note signed on April 17, 1981 by Mr. Alaoui Medaghri, Director of the Tax Division of the Ministry of Finance of Morocco and Mr. John Redecker, then Economic Counselor of the U.S. Embassy at Rabat, Morocco, explains that the Moroccan branch profits tax applicable to profits of Moroccan branches of U.S. companies is subject to the 10 percent limitation provided in Article 10(2)(b) with respect to parent-subsidiary dividends.

TECHNICAL EXPLANATION OF THE PROTOCOL, SIGNED ON SEPTEMBER 19, 1980, AMENDING THE CONVENTION BETWEEN THE UNITED STATES AND NORWAY WITH RESPECT TO THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND PROPERTY, SIGNED ON DECEMBER 3, 1971

INTRODUCTION

In this technical explanation of the Protocol signed on September 19, 1980 ("the Protocol"), references are made to the Convention between the United States of America and the Kingdom of Norway for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Property signed on December 3, 1971 (the "1971 Convention"). The term "the Convention" means the 1971 Convention as amended by the Protocol. The references to the 1971 Convention are intended to put various provisions of the Protocol into context. The technical explanation does not, however, provide a complete comparison between the Protocol and the provisions of the 1971 Convention amended by the Protocol. Moreover, neither the Protocol nor the technical explanation is intended to have implications for the interpretation of the 1971 Convention.

The technical explanation is an official guide to the 1971 Convention as amended by the Protocol. It reflects policies behind particular provisions as well as understandings reached with respect to the interpretation and application of the Convention.

Article I

Article I of the Protocol amends two Articles of the 1971 Convention -- Article 1 (Taxes Covered) and Article 23 (Relief from Double Taxation) -- relevant to U.S. foreign tax credits for certain payments to Norway.

These amendments take account of certain changes made in Norwegian law in 1975. Pursuant to the Act of June 13, 1975, Norway adopted a new revenue raising measure (the "special tax") with respect to income from submarine petroleum resources in Norway. The special tax is imposed on income from, among other activities, exploration or exploitation of submarine oil or gas. The rate of the special tax, as provided in 1980 legislation which amended the Act of June 13, 1975, is 35 percent. The special tax is not deductible in computing liability for the Norwegian national and municipal taxes on income. Losses or deficits with respect to offshore activities and up to 50 percent of losses or deficits attributable to activities other than offshore petroleum activities are taken into account in determining liability for the national and municipal taxes on income.

The special tax allows for the deduction of expenses attributable to oil and gas operations and provides a special "uplift" deduction. No losses or deficits arising in a year from other activities are deductible in computing liability for the special tax. The gross income and value of stocks of petroleum subject to the special tax are generally assessed according to a norm price stipulated retroactively by the King of Norway. The norm price for a period applies to transactions between related and unrelated persons and is based on the price at which petroleum could have been sold between independent parties in a fair market. In this regard, realized and quoted prices for contemporaneous sales of petroleum of the same or corresponding types are taken into account along with necessary adjustments for quality variations and other relevant factors. Before a norm price is stipulated, Norway notifies affected parties and gives them an opportunity to issue statements and, if necessary, pursue administrative and judicial appeals on the issue of whether the norm price, as it applies to all persons, has been properly determined.

The special tax was enacted after the 1971 Convention was signed, did not replace any comparable Norwegian measure in effect in 1971 and contains several features different from the 1971 Norwegian taxes specifically covered by the 1971 Convention. The Protocol amends the 1971 Convention to assure treaty coverage of the special tax. The Protocol also removes any doubt about coverage of the Norwegian national and municipal taxes on income, as affected by enactment of the special tax.

Thus, paragraph (1) of Article I of the Protocol amends paragraph (2) of Article 1 of the 1971 Convention to specify that the Norwegian taxes which are the subject of the Convention include the following taxes, as in effect on September 19, 1980, and any taxes substantially similar to such taxes enacted after that date: the national and municipal taxes on income (including contributions to the tax equalization fund); the special tax administered under section 5 of the Act of June 13, 1975, No. 35, relating to the taxation of submarine petroleum resources. The taxes imposed by Norway and specified in subparagraph (b) of paragraph (1) of Article 1 of the 1971 Convention, and any taxes substantially similar to those taxes imposed in addition to, or in place of those taxes after December 31, 1971, are also the subject of the Convention.

New subparagraph (b) of paragraph (2) of Article 1 assures that the term "Norwegian tax", which is used in paragraph (1) of Article 6 (Shipping and Air Transport) and, with modifications, in new paragraph (1) of Article 23, includes both the taxes described in new paragraph (2) of Article 1 and those described in existing subparagraph (b) of paragraph (1) of Article 1.

Paragraph (2) of Article I of the Protocol amends paragraph (1) of Article 23 of the 1971 Convention. New paragraph (1) of Article 23 provides that the United States shall allow to a resident or a citizen of the United States as a credit against U.S. tax on income the appropriate amount of income taxes imposed by Norway. In addition, in the case of a U.S. company owning at least 10 percent of the voting stock of a company which is a resident of Norway and from which the U.S. company receives dividends in any taxable year, the United States agrees by way of new paragraph (1) to allow as a credit against the United States tax on income the appropriate amount of income taxes imposed by Norway on the company which is a resident of Norway and with respect to the profits out of which the dividends are paid.

For purposes of applying the United States foreign tax credit in relation to taxes paid or accrued to Norway, new paragraph (1) of Article 23 provides that the Norwegian taxes referred to in subparagraph (b) of paragraph (1) and new paragraph (2) of Article 1 are considered to be income taxes and are allowed as credits against U.S. tax on income, subject to the rules of paragraph (1) of Article 23. New paragraph (1) of Article 23 does not cover as income taxes the Norwegian national and municipal taxes on capital, the municipal tax on real property, or any taxes substantially similar to such taxes on capital and real property imposed after December 3, 1971.

New subparagraph (b) of paragraph (1) of Article 23 provides that the appropriate amount allowed as a credit pursuant to new subparagraph (a) of paragraph (1) of Article 23 is based upon the amount of income taxes paid or accrued to Norway. Whether an amount is paid or accrued is determined under the Internal Revenue Code of 1954 ("the Code"). Subparagraph (b) provides further that direct and deemed paid credits allowed under the Convention by the United States pursuant to paragraph (1) shall not exceed the limitations provided by the Code for the taxable year. Thus, as is generally the case under U.S. income tax conventions, provisions such as Code sections 901(c), 904, 905, 907, 908 and 911 apply for purposes of computing the allowable credit under paragraph (1).

New subparagraph (b) also provides Convention limitations on the U.S. foreign tax credit allowed under the Convention in the case of persons subject to the Norwegian special tax or to a substantially similar revenue measure imposed by Norway. The credit allowed under the Convention with respect to such persons is limited by subparagraph (b) to the amount of income taxes paid or accrued to Norway attributable to Norwegian source income, as determined under the Convention. Subparagraphs (b)(i) and (iii) impose three limitations on the credit allowed with respect to such persons under the Convention:

(1) with respect to income taxes paid or accrued to Norway on oil and gas extraction income from oil or gas wells in Norway, the amount allowed as a credit for a taxable year shall not exceed the maximum U.S. statutory corporate tax rate for the taxable year times the amount of oil and gas extraction income from oil or gas wells in Norway;

(2) with respect to income taxes paid or accrued to Norway on Norwegian source oil related income, other than oil and gas extraction income from oil or gas wells in Norway, the amount allowed as a credit for a taxable year shall not exceed the maximum U.S. statutory corporate tax rate for the taxable year times the amount of such Norwegian source oil related income;

(3) with respect to income taxes paid or accrued to Norway on other Norwegian source income (other than Norwegian oil and gas extraction income from oil or gas wells in Norway and other Norwegian source oil related income), the amount allowed as credit for a taxable year shall not exceed the maximum U.S. statutory corporate rate for the taxable year times the amount of such other Norwegian source income.

The amount of Norwegian taxes attributable to oil and gas extraction income from oil or gas wells in Norway is determined under the principles of section 907(c)(5) of the Code. Such U.S. principles are then used to determine the amount of Norwegian taxes attributable to other Norwegian source oil related income and other Norwegian source income. This attribution is necessary because neither the national tax, the municipal tax nor the special tax is imposed exclusively on what is, under U.S. rules, extraction income, other oil related income, or other income. And, the special tax is imposed on only part of the income subject to the national and municipal taxes.

New subparagraph (b) provides for a carryover of foreign tax credits with respect to income taxes paid or accrued to Norway on oil and gas extraction income from oil or gas wells in Norway. The carryover credits are limited by subparagraph (b)(ii) to the lesser of the amount of taxes paid or accrued to Norway on oil and gas extraction income from oil or gas wells in Norway that is not allowed as a credit under subparagraph (b)(i), or two percent of such taxable income for the taxable year. These credits may be carried to the two preceding or five succeeding taxable years, to the extent such credits are not deemed paid or accrued in a prior taxable year. The carryover credits are allowable in the year in which deemed paid or accrued subject to the extraction tax limitation of subparagraph (b)(i) and any relevant limitations provided by the Code, such as sections 904(a) and 907.

Similarly, subparagraph (b)(iii) provides for carryovers under the Convention for the amount of income taxes paid or accrued to Norway on Norwegian source oil related income (other than income described in subparagraph (b)(i)) and on other Norwegian source income. These carryover credits are allowable in the year in which deemed paid or accrued subject to the respective Convention limitations in subparagraphs (b)(ii) and (iii) of paragraph (1) and relevant Code limitations such as those of sections 904(a) and 907(b).

If the provisions of the Convention are relied upon to claim a foreign tax credit for Norwegian income taxes paid by a person subject to the special tax, and any such payments would not otherwise be creditable under the Code then: the limitations of the third sentence of new subparagraph (b) apply, whether or not the special tax is paid in the taxable year; all such Norwegian income taxes must be treated as provided in the Convention.

If the taxes paid or accrued to Norway by a person subject to the special tax are creditable under the Code, and such taxes exceed the proportion of U.S. tax that taxable income attributable to Norwegian sources (as determined under the Convention) bears to entire income, such taxes are creditable under the Code against U.S. tax with respect to income from other foreign sources on the same basis as other creditable taxes and subject to the limitations of the Code. Moreover, if a person subject to the special tax chooses in a year not to rely upon the provisions of the Convention relevant to a claim for a foreign tax credit for any amounts paid to Norway, then the Convention limitations contained in the third sentence of subparagraph (b) of new paragraph (1) would not apply in that year and, pursuant to the current overall foreign tax credit limitation of the Code, Norwegian taxes creditable under the Code and creditable taxes paid to any other country can offset U.S. tax on income from Norwegian and other foreign sources.

As stated above, Norway's domestic law uses the norm price in calculating petroleum income for purposes of Norwegian tax liability. The Government of Norway takes the position that under Norwegian law producers may appeal this price only on the issue of its accuracy for the producers as a group. It is the position of the United States that the provisions of the Protocol are not intended to have any implications for whether the provisions of the Convention (or the 1971 Convention) provide a basis for an appeal of the norm price as it applies to an individual producer.

Pursuant to paragraph (2)(a) of Article XIII of the Protocol, the amendments to Articles 1 and 23 made by Article I of the Protocol have effect beginning with the sixth taxable year preceding January 1 of the year in which the Protocol enters into force. Thus, if the United States and Norway exchange instruments of ratification of the Protocol on or before December 31, 1981, a calendar year U.S. taxpayer may claim the benefits of the amendments to Articles 1 and 23 beginning with his taxable year beginning on January 1, 1975.

Article II

Article II of the Protocol amends the 1971 Convention to provide special rules with respect to the taxation of business profits and wages attributable to certain offshore activities.

Article II adds a new Article 4A (Offshore Activities) to the Convention. Paragraph (1) of new Article 4A overrides the provisions of Article 4 (Permanent Establishment) and Article 13 (Independent Personal Services) to provide that a resident of a Contracting State carrying on activities in the other Contracting State in connection with the exploration or exploitation of the seabed and subsoil and the natural resources is deemed to be carrying on, in respect of those activities, a business in that State through a permanent establishment. This paragraph is not intended to apply to activities, such as leasing, which are passive.

Paragraph (2) of new Article 4A provides that the right to tax at source provided in paragraph (1) does not apply where the activities are carried on for 30 days or less, in the aggregate, in any period of 12 months. If, however, two or more related persons carry on substantially similar activities in a Contracting State, their activities are aggregated for purposes of determining whether the 30 day threshold has been crossed.

Paragraph (3) assures that the source basis exemption provided in Article 6 (Shipping and Air Transport) applies to profits from the operation in international traffic of ships or aircraft where the transportation is to a location where activities are being carried on in connection with the exploration or exploitation of the seabed and subsoil and their natural resources. The reference to transportation by a ship or aircraft in international traffic encompasses the use of tugboats and other similar vessels in international traffic in connection with exploration or exploitation activities.

Paragraph (4) of new Article 4A provides special rules with respect to the taxation of wages, salaries and other similar remuneration derived from labor or personal services performed in connection with the exploration or exploitation of the seabed. Paragraph (4) provides that such remuneration is not taxable by a Contracting State to the extent attributable to labor or personal services performed in that State for a period of 60 days in the taxable year by an individual resident in the other Contracting State even if the person has performed services in that State for more than 60 days in that year and is taxable by that State by reason of Article 14 (Dependent Personal Services).

In addition, if the labor or personal services are performed in Norway, the remuneration is not taxable by Norway if the services are performed on behalf of an employer who is a resident of the United States, the services are performed with respect to a petroleum reservoir which extends between Norway and any other State with which Norway has an agreement for joint exploitation of the reservoir and the exploitation is performed simultaneously in Norway and that other State. This limitation on Norway's right to tax on a source basis comes into force only by way of a separate agreement between the competent authorities of the United States and Norway. This agreement could be entered into force under the authority of Article 27 (Mutual Agreement Procedure).

Paragraph (5) of new Article 4A assures that a resident of a Contracting State performing services aboard a ship or aircraft covered by paragraph (3) of Article 4A receives the same tax treatment in the other Contracting State as do other employees performing services aboard ships and aircraft in international traffic. (See, in this regard, Article 14 (Dependent Personal Services).) Thus, wages, salaries and similar remuneration of a resident of a Contracting State performing such services are taxable in the other Contracting State if:

> (1) the individual is a member of the regular complement of a ship or aircraft covered by paragraph (3) of Article 4A and such ship or aircraft is operated by a resident of such other State; or
>
> (2) the individual's wages are not exempt from tax in that other State pursuant to paragraph (2) of Article 14.

Article III

Article III of the Protocol amends the rules of the 1971 Convention with respect to taxation by Norway of income from the operation in international traffic of ships or aircraft.

Article III replaces paragraph (1) of Article 6 (Shipping and Air Transport) with a new paragraph (1) which provides that income which a resident of the United States derives from the operation in international traffic of ships or aircraft is exempt from Norwegian tax. Thus, new paragraph (1) drops the requirement of the 1971 Convention that exemption from Norwegian tax depends, in part, upon where the ship or aircraft is registered. By deleting this requirement, the rules of paragraph (1) become generally parallel to these of paragraph (2).

Article IV

Article IV of the Protocol amends the provisions of the 1971 Convention to change both the maximum rate of tax that may be imposed by a Contracting State on certain dividends paid to a resident of the other Contracting State and the circumstances in which one State may impose tax on dividends paid to a resident of the other Contracting State.

Article IV of the Protocol replaces paragraph (2) of Article 8 (Dividends) with a new paragraph which provides that dividends derived from within one Contracting State by a resident of the other Contracting State may not be taxed by the first-mentioned State at a rate of tax exceeding 15 percent of the gross amount actually distributed. Thus, new paragraph (2) deletes the provision of the 1971 Convention which limited the rate of tax imposed on certain dividends to 10 percent.

This amendment reflects certain reductions in Norway's corporate tax burden and Norway's desire to achieve a consistent rate of tax of 15 percent on dividends paid by Norwegian corporations. Norway has also renegotiated its income tax conventions with other countries to obtain this result. It was agreed that if the Government of Norway were to substantially increase its corporate tax burden by altering the rates of its split-rate corporate tax, or by taking other measures such as increasing the Norwegian corporate reserve requirement, Norway would consent to a renegotiation of the rates of withholding on dividends.

Article IV also amends paragraph (4) of Article 8. New paragraph (4) provides that dividends paid by a corporation of one of the Contracting States are exempt from tax by the other Contracting State except if the recipient of the dividends is a resident of the second-mentioned State; or, the recipient of the dividends has a permanent establishment in the second-mentioned State and the dividends are attributable to such permanent establishment.

In addition, where a corporation of Norway pays dividends out of profits attributable to one or more permanent establishments which the corporation had in the United States, the United States may tax such dividends provided that the profits are attributable to such permanent establishment(s) and constitute at least 50 percent of the corporation's gross income from all sources for the taxable year. If such a dividend is derived by a resident of Norway, other than a citizen of the United States, and the dividend is not attributable to a United States permanent establishment of the resident, the U.S. tax on the dividend is limited to 15 percent of the gross amount actually distributed, as provided in new paragraph (2) of Article 8. If such a dividend is derived by a resident of a State other than Norway, then the U.S. tax on the dividend is not limited by the provisions of the Convention. Also, new subparagraph (b) of paragraph (4) provides that a dividend paid by a Norwegian corporation to a citizen of the United States is taxable by the United States whether or not the citizen is a resident of Norway. Subparagraph (b) of paragraph (4) reflects the general rule that the United States may tax its citizens as if the Convention had not come into effect. See paragraph (3) of Article 22 (General Rules of Taxation).

Article V

Article V of the Protocol replaces Article 9 (Interest) of the 1971 Convention to provide new rules with respect to the taxation of interest derived within one Contracting State by a resident of the other Contracting State.

New Article 9 provides that interest derived from sources within one Contracting State by a resident of the other Contracting State is exempt from tax by the first-mentioned State in any calendar year in which the domestic law of either Contracting State exempts such interest from tax. Thus, so long as Norway continues to exempt from Norwegian tax interest derived from within Norway (not attributable to a permanent establishment in Norway) by persons not resident in Norway, the provisions of paragraph (1) of new Article 9 would exempt a resident of Norway from U.S. tax on interest income derived from sources within the United States (not attributable to a permanent establishment in the United States). Also, if the Code were changed, for example, to exempt from U.S. tax U.S. source interest (not effectively connected with the conduct of a trade or business within the United States) paid to a person not resident in the United States, paragraph (1) would exempt from any future Norwegian tax interest (not attributable to a Norwegian permanent establishment) derived from Norway by a resident of the United States.

In the event that for a calendar year neither the domestic law of Norway nor the Code exempts, for example, interest paid to nonresidents, then pursuant to paragraph (1) of new Article 9 such interest derived from sources within one of the Contracting States by a resident of the other Contracting State may be taxed by both Contracting States. Pursuant to paragraph (2) of new Article 9, however, the rate of tax imposed by a Contracting State on interest derived from sources within that State by a resident of the other Contracting State is limited to 10 percent of the gross amount of the interest. Moreover, there are five circumstances where, notwithstanding the general right to tax at 10 percent, interest derived from sources within a Contracting State by a resident of the other Contracting State is exempt from tax in the first-mentioned State:

(1) the interest is beneficially owned by, or is paid by, a Contracting State, a political subdivision or

local authority thereof or an instrumentality, subdivision or authority of a Contracting State which is not subject to tax by that State;

(2) the interest is beneficially owned by a resident of Norway or the United States, as the case may be, with respect to debt obligations guaranteed or insured by that State, a political subdivision or local authority of such State or an instrumentality, subdivision or authority of such State which is not subject to tax by that State;

(3) the interest is paid by a purchaser to a seller, who is a resident of the other Contracting State, in connection with a commercial credit resulting from deferred payments for goods, merchandise or services;

(4) the interest is paid with respect to a loan of any nature made by a bank;

(5) the interest is paid with respect to an obligation outstanding on September 19, 1980.

Paragraph (4) defines the term "interest" for purposes of the Convention. The term "interest" as used in the Convention means income from bonds, debentures, government securities, notes or other evidences of indebtness, whether or not secured, and debt-claims of every kind, as well as other income which, under the taxation law of the Contracting State in which the income has its source, is assimilated to income from money lent. The deletion from the definition of interest of the phrase "whether or not secured and whether or not carrying a right to participate in profits . . .", which appears in the definition of "interest" in Article 9 of the 1971 Convention, is not intended to change the substance of the definition of interest in the 1971 Convention.

Paragraph (5) of new Article 9 clarifies the relationship between provisions of Article 9 and those of Article 5 (Business Profits). Paragraph (5) provides that if a resident of one of the Contracting States is the beneficial owner of interest derived from sources within the other Contracting State and he has a permanent establishment in that other State to which the interest is attributable, then such income is taxable in that other State as "industrial or commercial profits" pursuant to paragraph (3)(a) of Article 5.

New paragraph (6) parallels paragraph (4) of Article 9 of the 1971 Convention. Pursuant to paragraph (6) the provisions of new Article 9 do not apply to any interest paid between related persons that exceeds amount which would been paid to an unrelated person. Any such excess payment may be taxed by Norway and the United States, each according to its own law, including the provisions of the Convention where applicable.

Paragraph (7) sets forth the general rule that a Contracting State may not impose tax on interest paid by a resident of the other Contracting State to a person not resident in the first-mentioned State. Paragraph (7) provides further, however, that the first-mentioned State retains the right to tax interest where:

(1) the interest is treated as income from sources within the first-mentioned State pursuant to paragraph (2) of Article 24 (Source of Income);

(2) the interest is attributable to a permanent establishment in the first-mentioned State which belongs to the recipient of the interest.

(3) the first-mentioned State is the United States and the interest is paid by a Norweigan corporation to a citizen of the United States resident in any State.

The provisions of paragraph (7) of new Article 9 parallel the provisions of paragraph (5) of Article 9 of the 1971 Convention.

Pursuant to subparagraph (b) of paragraph (2) of Article XIII of the Protocol, the 10 percent tax that could be imposed by the State of source pursuant to new Article 9 could only be imposed on amounts paid on or after the first day of the sixth month next following the date on which the exchange of instruments of ratification of the protocol takes place. As explained above, however, such tax could not be imposed in any calendar year in which, for example, either Norway or the United States exempts from tax under its domestic law interest paid to nonresidents.

Article VI

Article VI of the Protocol revises the rules of the 1971 Convention concerning the taxation of capital gains. Paragraph (1) of Article VI was negotiated in anticipation of amendments to the Code authorizing more effective source basis taxation of gains attributable to real property in the United States.

Paragraph (1) of Article VI adds two provisions to paragraph (1) of Article 12 (Capital Gains) to broaden the existing exceptions to the general rule of paragraph (1) of Article 12. That general rule is that a resident of one of the Contracting States is exempt from tax by the other Contracting State on gains from the sale or exchange or other disposition of capital assets. The first provision, new subparagraph (b) of paragraph (1) of Article 12, authorizes the other Contracting State to tax income from the sale or exchange or other disposition of capital assets if the income is derived from the sale or exchange or other disposition of stock of a corporation the property of which consists principally of real property situated within the other Contracting State, or an interest in a partnership, trust or estate the property of which consists principally of real property situated within the other Contracting State. For the purposes of this provision the term "real property" includes stock of a corporation the property of which consists principally of real property situated within the other Contracting State or an interest in a partnership, trust or estate the property of which consists principally of real property sitauted within the other Contracting State.

It should be noted that the provisions of Article 26 (Nondiscrimination) are not intended to override the right of the United States to impose the tax provided in Code section 897 under new subparagraph (b) of paragraph (1) of Article 12.

The second provision, new subparagraph (c) of paragraph (1) of Article 12, authorizes the other Contracting State to tax income from the sale, exchange or other disposition of stock of a corporation which is a resident of that State. Such income may be taxed by that State, however, only if two requirements are met:

(1) the recipient of the gain owns within the 12 months preceeding such sale, exchange or other disposition more than 25 percent of the stock of that corporation; and

(2) more than 50 percent of the fair market value of the gross assets of that corporation used in its trade or business are physically located in that State on the last day of each of the three taxable years preceeding the sale, exchange or other disposition (or if the corporation has been in existence for less than 3

years, on the last day of each preceeding taxable year of the corporation).

Paragraph (2) of Article VI makes conforming amendments to Article 12 to reflect changes made by Article VI of the Protocol to paragraph (1) of Article 12. Thus, paragraph (3) of Article 12 of the 1971 Convention is deleted and the cross references in existing paragraph (4) of Article 12 are modified and incorporated in new paragraph (3).

Paragraph (3) of Article VI conforms and expands a cross reference to Article 12 in Article 24 (Source of Income). New paragraph (8) of Article 24 provides that income from gains described in paragraph (1) of Article 12 derived by a resident of a Contracting State and which may be taxed by the other Contracting State is treated as income from sources within that other Contracting State for the purposes of the Convention. This source rule, like the other source rules of Article 24, is revelant for purposes of applying the United States credit in relation to taxes paid to Norway under the Convention. See paragraph (1) of Article 23 (Relief from Double Taxation).

Article VII

Article VII makes two changes to the 1971 Convention with respect to the taxation of services income of artistes and athletes.

Paragraph (1) of Article VII amends subparagraph (c) of paragraph (2) of Article 13 (Independent Personal Services) of the 1971 Convention. New subparagraph (c) provides that when an artiste or athlete performs services in an independent capacity in a Contracting State and such person is a resident of the other Contracting State, the first-mentioned State may tax the income derived from such services if the artiste or athlete is present in the first mentioned State more than a total of 90 days during the taxable year or such income exceeds, in the aggregate, $10,000 (or its equivalent in Norwegian Kroner) during the taxable year. In comparsion subparagraph (c) of Article 13 of the 1971 Convention allows source basis taxation if the income from such services exceeds in the aggregate $3,000 U.S. dollars (or its equivalent in Norwegian Kroner) during the taxable year. As provided in the 1971 Convention, income from such services is also taxable by the State in which the services are performed if the individual is present in that State for a period or periods aggregating 183 days or more in the taxable year or the individual maintains a fixed base in that State for a period or periods aggregating 183 days or more in a taxable year. See subparagraphs (a) and (b) of paragraph (2) of Article 13.

Paragraph (2) of Article VII adds a new Article 14A (Artistes and Athletes) which concerns taxation of income in respect of activities exercised by an entertainer or an athlete in his capacity as such which accrues to a person other than the entertainer or athlete. New Article 14A provides that in these circumstances such income is taxable in the Contracting State in which the activities of the entertainer or athlete are exercised, notwithstanding the provisions of Article 5 (Business Profits), Article 13 (Independent Personal Services) or Article 14 (Dependent Personal Services). New Article 14A provides that income of an entertainer or athlete is deemed not to accrue to another person if it is established by the entertainer or athlete that neither the entertainer or athlete nor any persons related thereto participate directly or indirectly in the profits of such other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions or other distributions.

Article VIII

Article VIII amends the provisions of the 1971 Convention concerning the taxation of social security payments.

Article VIII changes existing Article 19 to provide that a citizen of the United States receiving social security payments and other public pensions paid by Norway is taxable only by Norway whether the citizen resides in the United States or in any other State. New Article 19 retains the rule of the 1971 Convention that social security payments and other public pensions paid by one of the Contracting States to an individual who is a resident of the other Contracting State are taxable only in the first-mentioned State. Article 19 does not apply to payments described in Article 17 (Governmental Functions).

Article IX

Article IX of the Protocol amends paragraph (3) of Article 22 (General Rules of Taxation) to assure that the United States may tax as a citizen a former citizen whose loss of citizenship has as one of its principal purposes the avoidance of income tax. The authority to impose U.S. tax with respect to such former citizens is limited by new paragraph (3) to a period of 10 years following the loss of citizenship.

Article X

Article X of the Protocol amends provisions of the 1971 Convention concerning relief from double taxation granted in Norway with respect to income derived from U.S. sources.

Paragraph (2) of Article X amends subparagraph (c) of paragraph (2) of Article 23 (Relief from Double Taxation) which obligates Norway to allow a foreign tax credit in a case where a Norwegian corporation receives dividends from a U.S. corporation in which it owns 10 percent or more of the stock. Under new subparagraph (c) Norway will continue to be obligated to give a credit against the tax otherwise payable by the Norwegian corporation for U.S. tax imposed on the U.S. corporation. The credit in Norway shall, however, be for that part of the United States tax imposed on the profits of the United States corporation out of which the dividends were paid in the proportion that the dividends received bear to the accumulated profits of the United States corporation in excess of such United States tax. Subparagraph (c) requires, moreover, that the Norwegian corporation claiming a credit against its Norwegian tax with respect to such United States tax must recognize as income in the year in which the dividend is received an amount equal to such credit. New subparagraph (c) also provides that the Norwegian credit shall not exceed the part of the Norwegian tax, as computed before the credit is given, which is appropriate to the income derived from sources in the United States under rules set forth in Article 24 (Source of Income).

Paragraph (3) of Article X of the Protocol adds a new subparagraph (d) to paragraph (2) of Article 23. New subparagraph (d) provides that in the case of a resident of Norway who derives income from offshore activities which may be taxed in the United States, Norway may also tax such income. Norway shall allow, however, as a credit against the tax in Norway on such income an amount equal to the tax paid in the United States. This credit allowed in Norway shall not, however, exceed that part of the Norwegian tax, as computed before the credit is given, which is attributable to the income which may be taxed in the United States.

Paragraph (1) of Article X of the Protocol amends subparagraph (a) of paragraph (2) of Article 23 to assure that the provisions of new subparagraphs (c) and (d), as well as the provisions of existing subparagraph (b), override the general rule of subparagraph (a) of paragraph (2). Under the general rule, Norway is commited to an exemption (with progression) with respect to certain income that may be taxed by or is exempt in the United States.

Article XI

Article XI makes two changes to Article 27 (Mutual Agreement Procedure). First, Article XI amends paragraph (4) of Article 27 to clarify that any agreement reached under Article 27 may be implemented notwithstanding any time limits in the domestic law of a Contracting State. Thus, with this amendment to Article 27, it will be clear that the United States competent authority can grant refunds of U.S. tax under Article 27 even if under the Code such refund would otherwise be barred by the U.S. statute of limitations.

Second, Article XI adds to Article 27 a rule found in several recent United States income tax conventions. This rule, which is in new paragraph (5) of Article 27, authorizes the competent authorities to agree to adjust upward, in light of economy developments, any amounts specified in the Convention in terms of currency.

Article XII

Article XII of the Protocol amends paragraph (3) of Article 28 (Exchange of Information) to clarify the means to be taken by a Contracting State in responding to a request from the other Contracting State for such information as is pertinent to carrying out the provisions of the Convention and of the domestic laws of the Contracting State concerning the taxes covered by the Convention. New paragraph (3) provides that if information is requested by a Contracting State in accordance with Article 28, the other Contractinig State shall obtain the information to which the request relates in the same manner and to the same extent as if the tax of the requesting State were the tax of the requested State and were being imposed by the requested State. In addition, the competent authority of the requested State shall, if so requested, provide information under Article 28 in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts or writings) to the same extent such depositions and documents can be obtained under the laws and administrative practices of the requested State which respect to its own taxes.

Article XIII

Article XIII of the Protocol provides rules with respect to ratification, entry into force, and effective dates of the Protocol. The Protocol enters in force upon the exchange instruments of ratification. The provisions of the Protocol have effect at three different times:

(1) in respect of credits against U.S. tax allowed pursuant to Article I of the Protocol, as of the sixth taxable year preceeding January 1 of the year in which the instruments of ratification of the Protocol are exchanged;

(2) in respect of tax withheld at the source, to amounts paid on or after the first day of the sixth month next following the date on which the instruments of ratification of the Protocol are exchanged;

(3) in respect of other taxes, for taxable years beginning on or after January 1 of the year following the year in which the instruments of ratification of the Protocol are exchanged.

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TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE REPUBLIC OF THE PHILIPPINES FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME SIGNED AT MANILA ON OCTOBER 1, 1976

Article 1. TAXES COVERED

Paragraph (1) designates the taxes of the Contracting States which are subject to the Convention with respect to the United States, the subject taxes are the Federal income taxes imposed by the Internal Revenue Code ("Code"), but not including sections 531 (accumulated earnings tax) and 541 (personal holding company tax). The Convention only applies to taxes on income contained in the Internal Revenue Code. Thus, the Convention does not, for example, apply to the excise tax under Code section 1491. Also the Convention does not apply to U.S. social security taxes and the Federal unemployment tax.

In the case of the Philippines, paragraph (1) provides that the Convention applies to the income tax imposed by Title II of the National Internal Revenue Code ("Philippine Code"), but not including taxes imposed under sections 25 (additional tax on improperly accumulated earnings) and 63 (personal holding company tax).

Pursuant to paragraph (2), the Convention will also apply to taxes substantially similar to those covered by paragraph (1) which are imposed in addition to, or in place of, existing income taxes, after October 1, 1976, (the date of signature of the Convention).

Paragraph (3) provides that the competent authority of each Contracting State will notify the competent authority of the other Contracting State of any amendment of the tax laws referred to in paragraph (1) or (2), and of the adoption of substantially similar taxes imposed in addition to, or in place of, the taxes referred to in paragraph (1), by transmitting the texts of such amendments or statutes at least once a year. Paragraph (4) provides for a similar annual exchange with respect to the publication of material concerning the application of the Convention, whether in the form of regulations, rulings or judicial decisions.

Article 2. GENERAL DEFINITIONS

Paragraph (1) sets out definitions of certain basic terms used in the Convention. Unless the context otherwise requires, the terms defined in this paragraph have a uniform meaning throughout the Convention.

It should be noted that a number of important terms are defined elsewhere in the Convention.

The term "United States" means the United States of America. When used in the geographical sense, the term means the states of the United States and the District of Columbia. Thus, the Convention does not apply to the possessions of the United States or the Commonwealth of Puerto Rico. The term "United States" also includes the territorial sea and, as provided in section 638 of the Code, the continental shelf of the United States. The term "Philippines" means the Republic of the Philippines. When used in a geographical sense, the term means the territory comprising the Republic of the Philippines.

The term "Contracting State" is defined to mean the United States or the Philippines as the context requires.

The term "person" includes an individual, a partnership, or corporation, an estate or a trust.

The term "United States corporation" is defined as a corporation, or any unincorporated entity which is treated as a corporation for United States tax purposes, which is created or organized in or under the laws of the United States, any state thereof, or the District of Columbia. A "Philippine corporation" is defined as a corporation, or any unincorporated entity which is treated as a corporation for Philippine tax purposes, which is created or organized in the Philippines or under its laws. Under section 84(b) of the Philippine Code, the term "corporation" includes partnerships, no matter how created or organized, other than general professional partnerships. A general professional partnership is formed for the sole purpose of exercising a common profession, no part of the income of which is derived from engaging in a trade or business. Thus, a partnership formed in the United States which is engaged in a trade or business in the Philippines is considered to be a corporation for Philippine tax purposes. Nonetheless, for purposes of the Treaty, that partnership will not be considered to be a Philippine corporation within the meaning of paragraph (1)(e)(ii) since it was not created or organized in or under the laws of the Philippines.

With respect to the United States, the term "competent authority" means the Secretary of the Treasury or his delegate. With respect to the Philippines, it means the Secretary of Finance or his delegate. The term "tax" means those taxes imposed by the United States or the Philippines to which the Convention applies by virtue of Article 1 (Taxes Covered). However, as provided in paragraph (4) of Article 24 (Nondiscrimination), the term "taxes" or "taxation" means, for purposes of that article, taxes or taxation of every kind imposed at the national, state, or local level.

The term "international traffic" is defined as any transport by a ship or aircraft operated by a resident of one of the Contracting States except where such transport is confined solely between places within a Contracting

State. Thus, for example, coastal shipping along the Atlantic coast of the United States is not international traffic. However, if a ship operated by a resident of the Philippines transports goods from Canada to the United States, leaving some of the goods in San Francisco and the remainder in San Diego, the portion of the voyage between San Francisco and San Diego is international traffic.

Paragraph (2) provides that any term used in the Convention which is not defined therein shall, unless the context otherwise requires, have the meaning which it has under the laws of the Contracting State whose tax is being determined. However, where a term has a different meaning under the laws of the Philippines and the United States or where the meaning under the laws of one of the Contracting States is not readily determinable, the competent authorities may for purposes of the Convention establish a common meaning in order to prevent double taxation or to further any other purpose of the Convention.

Article 3. FISCAL RESIDENCE

This Article sets forth rules for determining the residence of individuals, corporations, and other persons for purposes of the Convention. Residence is important because, in general, only a resident of one of the Contracting States may qualify for the benefits of the Convention.

Under paragraph (1), the term "resident of the Philippines" means a Philippine corporation (as defined in Article 2 (General Definitions)) or any other person (except a corporation or any entity treated as a corporation for Philippine tax purposes) resident in the Philippines for purposes of Philippine tax. Thus, for example, a partnership formed in the United States which engages in a trade or business in the Philippines and is treated as a corporation under Philippine tax law is not a resident of the Philippines. It does not meet the condition of paragraph (1)(a)(i) since it is not a Philippine corporation as defined in Article 2 and it does not meet the condition of paragraph 1(a)(ii) since it is an entity treated as a corporation for Philippine tax purposes. Under paragraph (1) of Article 6 (General Rules of Taxation), such a partnership may be taxed by the Philippines only on income from sources therein, to the extent the partnership is treated as a resident of the United States under paragraph (1)(b)(ii). Similarly "resident of the United States" means a United States corporation (as defined in Article 2) and any other person (except a corporation or any entity treated as a corporation for United States tax purposes) resident in the United States for purposes of United States tax. Thus, a resident of the United States includes a resident alien individual who is subject to tax in the United States on his worldwide income and a resident citizen, but under no circumstances, a foreign corporation.

A citizen of the United States or the Philippines is not automatically a resident of the United States or the Philippines for purposes of this Convention. An individual's residence is determined on the basis of whether the individual is treated as a resident for tax purposes by a

Contracting State. An individual who is a resident of both Contracting States will be deemed to be a resident of the Contracting State in which he has his permanent home, his center of vital interests (closest personal and economic relations), a habitual abode, or his citizenship, in the order listed. If the issue is not settled by these tests, the competent authorities will decide by mutual agreement the one Contracting State of which he will be considered to be a resident.

The Convention provides that a partnership, estate or trust, in the case of the United States, and a professional partnership, estate, or trust, in the case of the Philippines, is a resident of the applicable Contracting State only to the extent that the income derived by such person is subject to tax in such Contracting State as the income of a resident. For example, under United States law, a partnership is never, and an estate or trust is often not, taxed as such. Under the Convention, in the case of the United States income received by a partnership, estate, or trust will not qualify for the benefits of the Convention unless such income is subject to tax in the United States as the income of a resident. Thus, for United States tax purposes, the treatment of income received by a partnership will be determined by the residence and taxation of its partners with respect to that income rather than by whether the partnership is resident in the United States by engaging in a trade or business here. To the extent the income of the partners is subject to United States tax as the income of residents of the United States, the partnership will be treated as a resident of the United States. Similarly, the treatment of income received by a trust or estate will be determined by the residence and taxation of the person subject to tax on such income, which may be the grantor, the beneficiaries or the trust or estate itself, as the case may be.

The fact that a charitable trust or pension fund is exempt from tax in the country in which it is otherwise resident is not to be construed to deny such exempt trust or fund resident status under this Convention.

Article 4. SOURCE OF INCOME

This Article contains the source rules which are to be used in applying the provisions of the Convention. For example, under Article 6 (General Rules of Taxation), one Contracting State may tax a resident of the other Contracting State only on income from sources within the first-mentioned Contracting State (provided such resident is not a citizen of the first-mentioned Contracting State).

Paragraph (1) provides that, as a general rule, dividends will be treated as income from sources within a Contracting State if paid by a corporation of that Contracting State or if paid by a corporation of any State, provided that, in the latter case, at least 50 percent of such corporation's gross income from all sources for the 3-year period (or such part of that period as the corporation has been in existence) ending with the close of its taxable year preceding the declaration of the dividends was business profits attributable to a permanent establishment which such corporation had in that Contracting State. In such a case, only a pro rata portion of the dividend will be treated as income from sources within the applicable Contracting State. Such portion is the amount which bears the same ratio to the dividends as the amount of the business profits attributable to the permanent establishment bears to the corporation's gross income. If a dividend would be treated under paragraph (1) as income from sources within both Contracting States, the pro rata portion of the dividend which is deemed to be from sources within the Contracting State in which the permanent establishment is situated is considered to be from sources only within that Contracting State. The remaining portion of the dividend, if any, shall be considered to be from sources within the other State.

A counterpart to the dividend source rule of the Convention appears in Code section 861(a)(2)(B). However, under Code section 864(c)(4), only four types of income from sources outside the United States -- certain rents, royalties, or gains on sales of intangible property; certain dividends or interest, or gains or losses from sales of securities in connection with certain banking, financing and security trading businesses; certain sales of goods or merchandise through an office in the United States; and, certain income received by foreign life insurance companies -- can be considered to be effectively connected with the conduct of a trade or business within the United States. If, for example, the business profits of a permanent establishment maintained by a Philippine corporation is comprised entirely of income from sources outside the United States not specified in Code section 864(c)(4), the United States will not tax a dividend paid by the Philippine corporation even if more than 50 percent of that corporation's gross income is attributable to the permanent establishment. The United States foregoes its right to tax in such circumstances. Under paragraph (2) of Article 6 (General Rules of Taxation), the Convention will not increase a person's United States tax.

Under paragraph (2) of Article 4, interest will be treated as income from sources within a Contracting State only if paid by the Contracting State, a political subdivision or local authority thereof, or by a resident of that Contracting State. The one exception to this rule is that if interest is paid on an indebtedness incurred in connection with a permanent establishment which bears such interest, then such interest shall be deemed to be from sources within the State (whether or not a Contracting State) in which the permanent establishment is situated. This exception permits a Contracting State, under the proper circumstances, to impose a tax on interest borne by a permanent establishment therein, including a permanent establishment of a resident of a State other than a Contracting State. For example, if a resident of France has a permanent establishment in the Philippines which borrows money from a resident of the United States and bears the interest, the interest will be deemed to be from sources within the Philippines. However, the United States will not, because of Article 6 (General Rules of Taxation) and Code section 861 (a)(1)(C) and (D), impose a tax on interest received by nonresident alien individuals or foreign corporations from a foreign corporation having a permanent establishment in the United States unless 50 percent or more of the gross income of such corporation from all sources for the 3-year period ending with the close of its taxable year preceding the the payment of the interest (or such part of such period as the corporation has been in existence) was effectively connected with the conduct of a trade or business within the United States. Even where the United States imposes a tax, no tax will be imposed on the portion of such interest which bears the same ratio to the total amount of the interest as the gross income of the corporation which was not effectively connected with the conduct of a trade or business in the United States bears to that corporation's gross income from all sources.

In addition, the permanent establishment exception to the general source rule for interest will exempt interest from tax in the Contracting State in which the payor resides if the payor has a permanent establishment in a State other than a Contracting State in connection with which the indebtedness of which the interest is paid was incurred, such interest is borne by the permanent establishment and such interest is paid to a resident of the other Contracting State. This results, once again, from the restriction in paragraph (1) of Article 6 (General Rules of Taxation) that a resident of one Contracting State, not a citizen of the other Contracting State, may be taxed by the other Contracting State only on income from sources within that other Contracting State. For example, if a resident of the United States has a permanent establishment in France which borrows money from a resident of the Philippines and bears the interest, the interest will be deemed to be from French sources, even if paid by the United States resident. Thus, the United States may not tax such income unless the recipient-resident of the Philippines is a citizen of the United States or has a permanent establishment in the U.S. to which the income is attributable. The rules of Article 5 (Permanent Establishment) will be applied to determine whether the resident of the United States has a permanent establishment in France.

Paragraph (3) provides that royalties for the use of, or the right to use, property or rights will be treated as income from sources within a Contracting State only to the extent that such royalties are for the use of, or the right to use, such property or rights within that Contracting State. However, if a royalty is paid with respect to a liability to pay the royalty that was incurred in connection with a permanent establishment which bears that royalty, then such royalty shall be deemed to be from sources within the State (whether or not a Contracting State) in which the permanent establishment is situated. It is intended that such exception will be applied in a manner similar to the exception with respect to interest. However, the United States will not, because of Code sections 861(a)(4) and 862(a)(4), impose a tax on royalties received by nonresident aliens or foreign corporations from a foreign corporation having a permanent establishment in the United States except to the extent that the royalties are for the use of, or the privilege of using, the property in the United States or the recipient of the royalties is engaged in the active conduct of a business in the United States so that Code section 864(c)(4)(B)(i) applies.

Paragraph (4) provides that income (including royalties) to which Article 7 (Income from Real Property) applies will be treated as income from sources within a Contracting State only if the real property is situated in that Contracting State.

. Under paragraph (5), income received by an individual for his performance of labor or personal services, whether as an employee or in an independent capacity, will be treated as income from sources within a Contracting State only to the extent that such services are performed in that Contracting State. However, income from personal services performed aboard ships or aircraft operated by a resident of a Contracting State in international traffic will be treated as income from sources within that Contracting State if rendered by a member of the regular complement of that ship or aircraft. Notwithstanding the general rule and the above described exception, remuneration described in Article 20 (Governmental Functions) and payments described in Article 19 (Social Security Payments) paid from the public funds of a Contracting State or a political subdivision or local authority thereof will be treated as income from sources within that Contracting State only.

Paragraph (6) contains a general qualification to the preceding source rules. It provides that business profits attributable to a permanent establishment which the recipient, a resident of one Contracting State, has in the other Contracting State will be treated as income from sources within that other Contracting State. Business profits attributable to such permanent establishment may include any item of income described in paragraphs (1) through (4) if the item of income is effectively connected with the permanent establishment. See the discussion of paragraph (6) of Article 8 (Business Profits) for a discussion of the "effectively connected" concept.

Under paragraph (7), gross revenues from the operation of ships or aircraft in international traffic will be treated as from sources within a Contracting State to the extent the revenues are derived from outgoing traffic originating in that State. Thus, for example, gross revenues derived from transporting passengers and freight from Manila to Hawaii, non-stop aboard an airplane, are deemed to be derived from sources within the Philippines for purposes of the Convention.

Under paragraph (8), the source of any item of income not described in the preceding paragraphs of Article 4 will be determined by each Contracting State in accordance with its own law. However, if the source of any such item of income under the laws of one Contracting State is different from its source under the laws of the other Contracting State or if its source is not readily determinable under the laws of one of the Contracting States, the competent authorities of the Contracting States may, in order to prevent double taxation or further any other purpose of the Convention, establish a common source of the item of income for purposes of the Convention.

As mentioned previously, several of the source rules set out in this Article differ to some degree from those provided in the Code. Since paragraph (2) of Article 6 (General Rules of Taxation) provides that the Convention will not increase a person's United States tax, a taxpayer is entitled to use the more beneficial of the Code rules or the Convention rules in calculating his United States tax.

Article 5. PERMANENT ESTABLISHMENT

This Article defines the term "permanent establishment." The existence of a permanent establishment is relevant under Article 8 (Business Profits) to the taxation of business profits and in determining the applicability of other provisions of the Convention.

Under paragraph (1), the term "permanent establishment" means a fixed place of business through which a resident of one of the Contracting States engages in a trade or business. Illustrations in paragraph (2) of a permanent establishment include a seat of management; a branch; an office; a store or other sales outlet; a factory; a workshop; a warehouse; a mine, quarry or other place of extraction of natural resources; a building site or construction or assembly project or supervisory activities in connection therewith, provided the site, project, or activity continues for a period of more than 183 days; and, the furnishing of services, including consultancy services, by a resident of one Contracting State through employees or other personnel, provided activities of that nature continue (for the same or a connected project) within the other Contracting State for a period or periods aggregating more than 183 days. Under the building site or construction or assembly project or supervisory activities rule, the 183-day period begins only when work physically commences in the other Contracting State. For purposes of that rule, a series of contracts or projects which are interdependent both commercially and geographically is to be treated as a single project when applying the 183-day test. In that respect, it is similar to the furnishing services rule.

As a general rule, any fixed facility or premises through which a resident engages in a trade or business for an indefinite or substantial period of time will be treated as a permanent establishment unless it is used only for one or more of the activities described in paragraph (3). Paragraph (3) specifically provides that a permanent establishment does not include a fixed place of business if it is used only for one or more of the following:

(a) The use of facilities solely for the purpose of storage, display, or occasional delivery of goods or merchandise belonging to the resident;

(b) The maintenance of a stock of goods or merchandise belonging to the resident solely for the purpose of storage, display, or occasional delivery;

(c) The maintenance of a stock of goods or merchandise belonging to the resident solely for the purpose of processing by another person;

(d) The maintenance of a fixed place of business for the purpose of purchasing goods or merchandise, or for collecting information, for the resident;

(e) The maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research, or for similar activities which have a preparatory or auxiliary character, for the resident; or

(f) The furnishing of services, including the provision of equipment, in one of the Contracting States by a resident of the other Contracting State, including consultancy firms, in accordance with, or in the implementation of, an agreement between the Contracting States regarding technical cooperation. Such an agreement was signed at Manila on April 27, 1951. See Economic and Technical Cooperation Agreement with the Philippines, April 27, 1951, [1952] 3 U.S.T. 3707, T.I.A.S. 2498.

As noted, these exceptions are cumulative and a fixed place of business used only for one or more of these purposes will not be considered a permanent establishment under the Convention. It is intended that a building site or construction or assembly project or supervisory activities in connection therewith which does not exist for more than 183 days does not constitute a permanent establishment.

Under paragraph (4), a person acting in one Contracting State on behalf of a resident of the other Contracting State, other than an agent of an independent status to whom paragraph (5) applies, will be deemed to constitute a permanent establishment if such person has, and habitually exercises in that first-mentioned Contracting State, an authority to conclude contracts in the name of the resident, unless the exercise of the authority is limited to the purchase of goods or merchandise for the resident. Even if the person has no authority to conclude contracts in the name of the resident, he will be deemed to constitute a permanent establishment if he habitually maintains in the first-mentioned Contracting State a stock of goods or merchandise from which he regularly delivers goods and merchandise on behalf of the resident. Similar rules appear in Code section 864(c)(5)(A).

On the other hand, paragraph (5) provides that a resident of one Contracting State will not be deemed to have a permanent establishment in the other Contracting State merely because such resident carries on business in such other Contracting State through a broker, general commission agent, or any other agent of an independent status, where such broker or agent is acting in the ordinary course of his business.

However, if the activities of the agent are devoted wholly or almost wholly on behalf of that resident and the transactions between the agent and the resident are not made under arm's length conditions, the agent will not be considered to be an agent of independent status within the meaning of paragraph (5). Thus, for example, an agent will not lose his status as an independent agent merely because he acts exclusively or almost exclusively for a resident of the other Contracting State. Nor will an agent lose his status as an independent agent merely because he enters into transactions with the resident under non-arm's length conditions. However, where both such conditions exist, the agent, in effect, is no longer independent and paragraph (5) reflects that fact. Similar rules apply under Code section 864 (c)(5)(A)(ii). Regulations section 1.864-7(d)(3)(iii) indicates that an otherwise independent agent who acts exclusively or almost exclusively for one foreign principal may not be considered to be an agent of independent status in appropriate circumstances.

Paragraph (6) provides that, except with respect to reinsurance, a resident of a Contracting State will be deemed to have a permanent establishment in the other Contracting State if it collects premiums in that other Contracting State, or insures risks situated therein, through an employee or representative situated therein who is not an agent of independent status to whom paragraph (5) applies. A similar provision appears in the existing United States Convention with France.

Paragraph (7) provides that a resident of one Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because such resident sells at the termination of a trade fair or convention in the other Contracting State goods or merchandise which were displayed by such resident at that trade fair or convention. The trade fair exception is not intended to apply with respect to other goods in the resident's inventory. This exception appears in recent United States conventions.

Under paragraph (8), the fact that a corporation of one of the Contracting States controls or is controlled by or is under common control with a corporation of the other Contracting State or a corporation which carries on business in that other Contracting State (whether through a permanent establishment or otherwise) will not be taken into account in determining whether the activities or fixed place of business of either corporation constitutes a permanent establishment of the other corporation.

Paragraph (9) provides that the principles set forth in this Article are to be applied in determining whether there is a permanent establishment in a State other than one of the Contracting States or whether a person other than a resident of one of the Contracting States has a permanent establishment in one of the Contracting States. This is necessary for the proper application of paragraphs (2) and (3) of Article 4 (Source of Income). This paragraph is not intended to extend the benefits of the Convention to persons other than residents of the two Contracting States.

Article 6. GENERAL RULES OF TAXATION

Under paragraph (1), a resident of one Contracting State may be taxed by the other Contracting State on any income from souces within that other Contracting State and only on such income, subject to the limitations set forth in the Convention. For this purpose, the source rules contained in Article 4 (Source of Income) are to be applied. However, if the resident is a citizen of the other Contracting State, that Contracting State may tax the resident without regard to this paragraph because of the saving clause of paragraph (3).

Paragraph (2) contains the customary rule that the Convention will not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded by the laws of a Contracting State in the determination of tax imposed by it, or by any other agreement between the Contracting States. This rule reflects the principle that a convention should not increase the tax burden on residents of the Contracting States.

Paragraph (3) contains the traditional saving clause under which the United States reserves the right to tax its citizens and residents as if the Convention had not come into effect. However, because of paragraph (4), the saving clause does not apply in several cases in which its application would contravene policies reflected in the Convention which are specifically designed to extend treaty benefits to citizens or residents. Thus, the saving clause does not affect the provisions with respect to social security payments, relief from double taxation, nondiscrimination, or the mutual agreement procedure. Moreover, the saving clause does not affect the benefits of the Convention which are conferred upon individuals performing governmental functions, teachers, students, trainees, and diplomatic or consular officers who are neither citizens of, nor have immigrant status in, the Contracting State conferring such benefits. In the case of the United States, "immigrant status" means the individual has been admitted to the United States for permanent residence. The saving clause is reciprocal.

Paragraph (5) authorizes the competent authorities of the Contracting States to prescribe regulations necessary to carry out the provisions of the Convention. On the United States side, this authority is also provided by Code section 7805.

Article 7. INCOME FROM REAL PROPERTY

Under paragraph (1), income from real property, including royalties and other payments in respect of the exploitation of natural resources (e.g., oil wells), and gains from the alienation (sale, exchange or other disposition)of such property or of the right giving rise to such royalties or other payments may be taxed by the Contracting State in which the real property or natural resources are situated. For purposes of the Convention, interest on indebtedness secured by real property (e.g., mortgages) or secured by a right giving rise to royalties or other payments in respect of the exploitation of natural resources are not considered as income from real property.

Under paragraph (2), paragraph (1) applies to income derived from the usufruct, direct use, letting, or use in any other form of real property.

Article 8. BUSINESS PROFITS

Paragraph (1) sets forth the general rule that business profits of a resident of one Contracting State are exempt from tax by the other Contracting State unless the resident has a permanent establishment in the other Contracting State. Where there is a permanent establishment, only the business profits attributable to the permanent establishment can be taxed by that other Contracting State, unless the resident is a citizen of that other Contracting State. (See the saving clause in paragraph (3) of Article 6 (General Rules of Taxation).) Under paragraph (6) of Article 4 (Source of Income), business profits whether from sources within or without a Contracting State attributable to a permanent establishment which a resident of one Contracting State has in the other Contracting State will be considered to be from sources within that other Contracting State. Thus, items of income described in section 864(c)(4)(B) of the Code attributable to a permanent establishment situated in the United States will be subject to tax by the United States.

In determining the proper attribution of business profits under the Convention, paragraph (2) provides that both Contracting States will attribute to the permanent establishment such profits as it would reasonably be expected to derive if it were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the resident of which it is a permanent establishment. Paragraph (3) embellishes on that rule by providing that business profits derived from the sale of goods or merchandise of the same or similar kind as those sold, or from other business activities of the same or similar kind as those effected, through that permanent establishment, may be attributed to that permanent establishment if the sale or activities had been resorted to in order to avoid taxation.

Under paragraph (4), expenses, wherever incurred, which are reasonably allocable to business profits attributable to the permanent establishment, including executive and general administrative expenses, will be allowed as deductions in determining the business profits of the permanent establishment. However, in determining the amount of the deduction under paragraph (4) for expenses incurred by the head office, the deduction may be limited to the expense incurred without including the profit element for the head office. Moreover, no deductions will be allowed in respect of amounts paid or payable (other than reimbursement of actual expenses) by the permanent establishment to any office of the resident by way of royalties, fees, or other similar payments in return for the use of patents or other rights; commissions for specific services performed or for management; and, except for banking institutions, interest on money lent to the permanent establishment.

Paragraph (5) provides that no profits shall be attributed to a permanent establishment merely because of the purchase of goods or merchandise by that permanent establishment for the account of such resident of which it is a permanent establishment. Paragraph (2) does not override paragraph (5). Thus, where a permanent establishment purchases goods for its head office, the business profits attributed under paragraph (2) to the permanent establishment with respect to its other activities will not be increased by adding a notional figure for profits from purchasing.

Under paragraph (6), the term "business profits" means income derived from any trade or business whether carried on by an individual, corporation, or any other person, or group of persons, including the rental of tangible personal (movable) property. The term "business profits" also includes income from dividends, interest, and royalties, but only if the income is effectively connected with a permanent establishment. See paragraph (4) of Article 11 (Dividends), paragraph (5) of Article 12 (Interest) and paragraph (4) of Article 13 (Royalties).

The Convention contains no criteria for determining whether income is effectively connected with a permanent establishment. However, the "effectively connected" concept in the Convention is substantially similar to the "effectively connected" concept in section 864(c) of the Code. It is intended that the factors which apply under that Code section will apply with respect to this Convention.

Under paragraph (7), where business profits include items of income which are dealt with separately in other articles of the Convention, the provisions of those articles will not be affected by the provisions of this Article. Thus, for example, taxation of interest income will be controlled by Article 12 (Interest) and not by this Article. If the interest is effectively connected with a permanent establishment, paragraph (5) of Article 12 provides that this Article will apply.

Article 9. SHIPPING AND AIR TRANSPORT

Article 9 permits a Contracting State to impose a tax on the profits derived from sources therein by a resident of the other Contracting State from the operation of ships or aircraft in international traffic. In so providing, it departs from the shipping and air transport article which customarily appears in income tax conventions of the United States.

Under paragraph (1), profits derived by a resident of one Contracting State from sources within the other Contracting State from the operation of ships in international traffic may be taxed by both Contracting States. However, a limitation is placed on the amount of tax which may be imposed by the country of source. The tax imposed by the country of source, the "other Contracting State," may be as much as, but shall not exceed 1.5 percent of the gross revenues derived from sources in that State (as determined under paragraph (7) of Article 4 (Source of Income)) or the lowest rate of Philippine tax that may be imposed on profits of the same kind derived under similar circumstances by a resident of a third State, whichever is less. Under that formula, for example, a Philippine corporation which operates ships between Manila and Hawaii and which engages in no other trade or business will determine its United States income tax in the following manner. First, it will compute a tentative tax under Code section 882 on the taxable income which is effectively connected with the conduct of its trade or business within the United States, using the source rule which appears in Code section 863. Then, it will compute the limitation under paragraph (1) by multiplying its gross revenues from United States sources, using the source rule which appears in paragraph (7) of Article 4 (Source of Income), by 1.5 percent. The lower of those two figures is its United States income tax. The reciprocal exemptions of Code sections 872(b) and 883(a) do not apply to Philippine residents because the Philippines imposes a tax on the earnings of foreign carriers in the amount of 2.5 percent of their gross Philippine billings.

Paragraph (2) states that nothing in the Convention affects the right of a Contracting State to tax, under its domestic laws, profits derived by a resident of the other Contracting State from sources within the first-mentioned Contracting State from the operation of aircraft in international traffic. Thus, although the United States and the Republic of the Philippines have placed a limitation in the Convention on the taxation of income from the operation of ships in international traffic, they have not agreed to such a provision with respect to income derived from the operation of aircraft in international traffic. Such income will be taxed in accordance with the tax legislation of each of the Contracting States.

The tax under paragraphs (1) and (2) may be imposed notwithstanding any other provisions of the Convention, including Article 24 (Nondiscrimination). Under paragraph (2) of Article 24, a permanent establishment which a resident of one Contracting State has in the other Contracting State will not be subject in the other Contracting State to more burdensome taxes than a resident of that other Contracting State carrying on the same activites.

It is possible that, under this Article, United States residents operating ships and aircraft in international traffic may be subject to more burdensome taxation in the Philippines than Philippine corporations. For example, Philippine air carriers, other than Philippine Air Lines, and shipping companies enjoy recurring 10-year exemptions from Philippine income tax on income derived from international traffic. Philippine

Air Lines is subject to a franchise tax of 2 percent of gross income in lieu of all Philippine taxes. Should the President find that, with respect to profits from the operation of ships or aircraft in international traffic, United States citizens or corporations are being subjected to a higher effective rate of Philippine tax than are Philippine citizens, residents, or corporations, Articles 9 and 24 do not prevent the adjustment of United States income tax under Code section 896.

Paragraph (3) provides that paragraphs (1) and (2) apply to profits derived from the participation in a pool, a joint business venture, or in an international operating agency.

This Article is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Therefore, a Contracting State may tax income from international traffic derived by a resident of the other Contracting State without regard to this Article if such resident is a citizen of the first-mentioned Contracting State.

Article 10. RELATED PERSONS

This Article confirms the authority of the United States under section 482 of the Code. Thus, where a person subject to the taxing jurisdiction of a Contracting State (whether or not a resident thereof) and any other related person make arrangements or impose conditions between themselves which are different from those which would be made between independent persons, under paragraph (1), any income, deductions, credits or allowances which would, but for those arrangements or conditions, have been taken into account in computing the income or loss of, or the tax payable by, one of such persons, may be taken into account in computing the amount of the income subject to tax and the taxes payable by such person in that Contracting State.

Paragraph (2) sets forth an explicit formulation of the consequence of a redetermination made in accordance with paragraph (1) by a Contracting State to the income of one of its residents. In such event, the other Contracting State will, if it agrees with such redetermination and if necessary to prevent double taxation, make a corresponding adjustment to the income of a person in such other Contracting State related to such resident. In the case of the United States, any refunds of tax in respect of such an adjustment shall be made notwithstanding the statute of limitations. In situations where the other Contracting State disagrees with the redetermination, the two Contracting States will endeavor to reach agreement in accordance with the mutual agreement procedure in paragraph (2) of Article 25 (Mutual Agreement Procedure). For a discussion of the mutual agreement procedure and a fuller explanation of the operation of the statute of limitations with respect to adjustments see the discussion under Article 25.

Paragraph (3) provides that for purposes of the Convention a person is related to another person if either person owns or controls directly or indirectly the other, or if a third person or persons own or control directly or indirectly both. "Control" includes any kind of control, whether or not legally enforceable, and however exercised or exercisable.

Article 11. DIVIDENDS

Paragraph (1) provides that dividends derived from sources within one Contracting State by a resident of the other Contracting State may be taxed by both Contracting States. However, paragraph (2) limits the rate of tax imposed by the Contracting State of source to a rate not in excess of 25 percent of the gross amount of the dividends. If the dividend recipient is a corporation, the rate of tax imposed by the Contracting State of source may not exceed 20 percent of the gross amount of the dividend if during the part of the paying corporation's taxable year which precedes the date of payment of the dividend and during the whole of its prior taxable year (if any), at least 10 percent of the outstanding voting stock of the paying corporation was owned by the recipient corporation. These rate limitations do not affect the taxation of profits of the corporation which pays the dividends.

Paragraph (3) provides that dividends paid by a corporation of one of the Contracting States to a person other than a citizen or resident of the other Contracting State may be taxed by that other Contracting State only in limited circumstances. Such other Contracting State may impose tax if the dividends are treated as income from sources in that State under paragraph (1)(b) of Article 4 (Source of Income), but only on the portion of the dividend which is deemed to be income from sources within the other Contracting State. Moreover, the Philippines may only tax such a dividend if the Philippine branch profits tax described in paragraph (6) has not been paid with respect to the earnings distributed. In addition, the other Contracting State may impose tax if the recipient of the dividend has a permanent establishment or a fixed base in the State and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base.

Paragraph (4) provides that the limitations of paragraph (2) shall not apply if the recipient of the dividends derived from sources within a Contracting State, being a resident of the other Contracting State, carries on business in the first-mentioned Contracting State through a permanent establishment situated therein or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such a case, the dividends shall be treated as business profits subject to the provisions of Article 8 (Business Profits) or income from the performance of independent personal services subject to the provisions of

Article 15 (Independent Personal Services), as the case may be. If the recipient of the dividend is a citizen or resident of the source Contracting State, that Contracting State may tax the recipient without regard to this Article because of the saving clause of paragraph (3) of Article 6 (General Rules of Taxation).

Paragraph (5) provides that the term "dividends" as used in the Convention means income from shares, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights assimilated to income from shares by the taxation law of the State of which the corporation making the distribution is a resident.

Paragraph (6) relates to the Philippine branch profits tax. Under section 24(b)(2) of the Philippine Code, the Philippines imposes a tax of 20 percent upon profits which are remitted outside the Philippines by a Philippine branch office to its mother company. Paragraph (6) preserves the right of the Philippines to impose such a branch profits tax by providing that nothing in the Convention will be construed to prevent the Philippines from imposing on the earnings of a corporation (other than a Philippine corporation) attributable to a permanent establishment in the Philippines, a tax in addition to the tax which would be chargeable on the earnings of a Philippine corporation. Such Philippine branch profits tax will not exceed 20 percent of the amount of such earnings which have not been subjected to such additional tax in previous taxable years, and in accordance with Philippine law, will only be imposed when such earnings are remitted outside the Philippines. The term "earnings" means, for purposes of paragraph (6), business profits attributable to a permanent establishment for the year in issue and all previous years after deducting therefrom all Philippine tax imposed thereon other than the Philippine branch profits tax.

Article 12. INTEREST

Paragraph (1) provides that interest derived by a resident of one Contracting State may be taxed by both Contracting States. However, the rate of tax in the Contracting State of source is limited by paragraph (2) to a rate not in excess of 15 percent of the gross amount of the interest and, if the interest is derived with respect to public issues of bonded indebtedness, by paragraph (3) to a rate not in excess of 10 percent of the gross amount of the interest.

Paragraph (4) provides that interest beneficially derived by one of the Contracting States, or by an instrumentality of that Contracting State, will be exempt from tax by the other Contracting State. Under this rule, interest income derived by the Central Bank of the Philippines, the Federal Reserve Banks of the United States, the Export-Import Bank of the United States, the Overseas Private Investment Corporation (OPIC), and such other institutions of either Contracting State as the competent authorities may determine by mutual agreement on loans made to residents of the other Contracting State will be exempt from tax in that other State. The exemption also applies where a resident of a Contracting State receives interest income with respect to debt obligations guaranteed or insured by that Contracting State or an instrumentality thereof.

Paragraph (5) provides that the reduced rate of tax under paragraphs (2) and (3) and the exemption under paragraph (4) will not apply if the recipient of interest from sources within one Contracting State, being a resident of the other Contracting State carries on business through a permanent establishment situated therein or performs in that other State independent personal services from a fixed base situated therein and the debt claim in respect of which the interest is paid is effectively connected with such permanent establishment or fixed base. In such a case, the interest will be treated as business profits subject to the provisions of Article 8 (Business Profits) or income from the performance of independent personal services subject to the provisions of Article 15 (Independent Personal Services), as the case may be.

If excessive interest is paid to a related person, paragraph (6) provides that this Article does not apply to the excessive portion of the payment. The excessive portion may be taxed by each Contracting State according to its own laws, including the Convention where applicable. In the case of the United States, the excessive portion may be taxed as a dividend, in which case the provisions of Article 11 (Dividends) will apply.

Paragraph (7) defines interest for purposes of the Convention as income from debt-claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits. In particular, the term "interest" includes income from government securities and income from bonds or debentures, including premiums and prizes attached to such bonds, debentures or government securities and other income (such as original issue discount) which under the taxation laws of the Contracting State in which the income arises is assimilated to income from money lent.

This Article is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Therefore, interest derived by a citizen or resident of the source Contracting State may be taxed by that Contracting State without regard to this Article.

Article 13. ROYALTIES

Paragraph (1) provides that royalties derived by a resident of one Contracting State from sources within the other Contracting State may be taxed by both Contracting States. However, the rate of tax imposed by that other Contracting State on such royalties is limited under paragraph (2). If the royalties are derived from sources within the United States, the United States tax is limited to a rate which does not exceed 15 percent of the gross amount of those royalties. On the other hand, if the royalties are derived from sources within the Philippines, the tax is subject to three limitations. In general, the Philippine tax is limited to a rate which does not exceed 25 percent of the gross amount of the royalties. However, if the royalties are paid by a corporation registered with the Philippine Board of Investments and engaged in preferred areas of activity, the tax is limited to a rate which does not exceed 15 percent of the gross amount of the royalties. Notwithstanding such 25 percent and 15 percent limitations, the Philippine tax cannot exceed the lowest rate of Philippine tax that may be imposed on royalties of the same kind under similar circumstances to a resident of a third State. Thus, for example, because the Philippines agreed to limit its tax on film royalties to an amount not in excess of 10 percent of the gross amount of such royalties in its Income Tax Conventions with Sweden and Denmark, that limitation will apply to film royalties paid under similar circumstances to United States residents. Of course, if those 10-percent limitations are renegotiated upward by the Philippines the limitation with respect to the tax on United States residents will be affected. However, under paragraph (2) of Article 29 (Entry Into Force), such third-described limitation with respect to the tax on royalties will not have effect with respect to payments for the use of, or the right to use, a copyright of cinematographic films or films or tapes used for radio or television broadcasting until January 1, 1979.

The term "royalties" is defined in paragraph (3) as payments of any kind made as consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work, including copyrights of cinematographic films or films or tapes used for radio or television broadcasting, any patent, trademark, design, model, plan, secret process or formula, or other like right or property, or information concerning industrial, commercial, or scientific experience (know-how). The term "royalties" also includes gains derived from the sale, exchange, or other disposition of any such right or property which are contingent on the productivity, use, or disposition thereof. If the amounts realized are not so contingent, the provisions of Article 14 (Capital Gains) may apply.

Paragraph (4) provides that the tax rate limitations of paragraph (2) shall not apply if the recipient of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein, or performs in that other State professional services from a fixed base situated therein, and the right or property in respect to which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such case, the royalties will be treated as business profits subject to Article 8 (Business Profits) or income from the performance of independent personal services subject to tax under Article 15 (Independent Personal Services).

If excessive royalties are paid to a related person, paragraph (5) provides that this Article does not apply to the excessive portion of the royalty. The excessive portion may be taxed by each Contracting State according to its own laws, including the Convention where applicable. Thus, in the case of the United States, the excessive portion may be treated as a dividend or interest, or in whatever other manner is appropriate.

This Article is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Therefore, royalties derived by a citizen or resident of the source Contracting State may be taxed by that Contracting State without regard to this Article.

Article 14. CAPITAL GAINS

This Article sets forth the circumstances in which gains derived by a resident of one Contracting State may be taxed by the other Contracting State.

Under paragraph (1), gains from the alienation of tangible personal (movable) property forming part of the business property of a permanent establishment which a resident of a Contracting State has in the other Contracting State or gains from the sale of tangible personal (movable) property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including gains from the alienation of the permanent establishment (along or together with the whole enterprise) or the fixed base, may be taxed in that other State. However, gains derived by a resident of a Contracting State from the alienation of ships, aircraft or containers operated by such resident in international traffic will only be subject to tax in the State of the operator's residence, notwithstanding the fact that profits derived by such resident from sources within the other Contracting State from the operation of such ships or aircraft may be taxed by both States under Article 9 (Shipping and Air Transport). Gains which are considered to be royalties under paragraph (3) of Article 13 (Royalties) will only be taxed in accordance with the provisions of Article 13.

Paragraph (2) provides that gains from the alienation of any property other than those mentioned in paragraph (1) or those mentioned in Article 7 (Real Property) will only be taxed in the Contracting State of which the alienator is a resident.

If the recipient of the gain is a resident of one Contracting State and a citizen of the other Contracting State, that other Contracting State may tax the recipient without regard to this Article because of the saving clause of paragraph (3) of Article 6 (General Rules of Taxation).

Article 15. INDEPENDENT PERSONAL SERVICES

In dealing with the taxation of income from personal services, the Convention distinguishes between "independent" and "dependent" personal services. The Convention also provides special treatment with respect to individuals who are public entertainers.

Under paragraph (1), income derived by an individual resident of one Contracting State from the performance of personal services in an independent capacity may be taxed only by that Contracting State. However, under paragraph (2), such income derived from services performed in the other Contracting State may also be taxed in that other Contracting State in certain circumstances. Thus, if the individual has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities, he may be taxed by that State, but only on the income that is attributable to that fixed base (the term fixed base is synonymous with the term "permanent establishment" as described in Article 5 (Permanent Establishment)). Similarly, if the individual is present in the other Contracting State for a period or periods aggregating 90 days or more in the taxable year, he may be taxed by that State. Finally, if the gross remuneration derived in the taxable year from residents of the other Contracting State for the performance of personal services in an individual capacity in that other Contracting State exceeds $10,000 or its equivalent in Philippine pesos that other Contracting State may tax the income of that individual from the performance of those services. Since the $10,000 is gross remuneration, it includes any expenses, such as airfare, borne on behalf of or reimbursed to the individual performing the personal services. Article 15 also provides that the competent authorities may specify in an exchange of letters that the $10,000 limitation will be increased if circumstances warrant, i.e., if inflation reduces the real value of $10,000. Once increased, the limitation can be decreased by the competent authorities, but never to an amount less than $10,000.

Paragraph (3) makes clear that the other Contracting State referred to in paragraph (2) may impose its tax only on net income.

Under the saving clause of paragraph (3) of Article 6 (General Rules of Taxation), the other Contracting State may also tax any individual who is a citizen or resident of that other Contracting State without regard to this Article.

Personal services performed by an individual in an independent capacity are services performed for his own account where he receives the income and bears the losses arising from such services. If an individual is an independent contractor, he is considered to perform personal services in an independent capacity. Income from services in which capital is a material income-producing factor, however, will generally be governed by the provisions of Article 7 (Business Profits). Generally, the term "personal services in an independent capacity" includes, but is not limited to, services rendered as a director of a corporation or rendered by physicians, lawyers, engineers, architects, dentists, and accountants performing personal services as sole proprietors or partners. Services performed by employees, such as by an officer of a corporation, are dependent personal services to which Article 16 (Dependent Personal Services) applies.

Article 16. DEPENDENT PERSONAL SERVICES

This Article deals with the taxation in respect of dependent personal services. This Article is similar in many respects to Article 15 (Dependent Personal Services) of the OECD Model Convention. Under paragraph (1), wages, salaries, and similar remuneration derived by an individual who is a resident of one Contracting State from labor or personal services performed as an employee, including income from services performed by an officer of a corporation, may be taxed by that Contracting State, except as provided in Article 20 (Governmental Functions). In addition, except as provided by paragraphs (2) and (3) and in Articles 20 (Governmental Functions), 21 (Teachers), and 22 (Students and Trainees), remuneration from the performance of dependent personal services derived from sources within the other Contracting State may be taxed by that other Contracting State.

Under paragraph (2), dependent personal service income derived by an individual resident of one Contracting State will be exempt from tax by the other Contracting State if: (a) the individual is present in that other Contracting State for a period or periods aggregating less than 90 days in the taxable year; (b) the individual is an employee of a resident of the first-mentioned Contracting State or of a permanent establishment maintained in the first-mentioned Contracting State; and (c) the remuneration is not borne as such by a permanent establishment or fixed base which the employer has in the other Contracting State. Such income, however, may also be taxed by that other Contracting State without regard to this Article if the individual is a citizen or resident of that other Contracting State, because of the saving clause of paragraph (3) of Article 6 (General Rules of Taxation).

In the United States, remuneration from the performance of dependent services will be viewed as not having been borne by the permanent establishment or fixed base maintained in the United States if the employee is performing stewardship or overseeing functions for the benefit of a resident of or a permanent establishment maintained in the Philippines. However, the remuneration will be considered to be borne by the permanent establishment or fixed base maintained in the United States if the remuneration is paid for activities other than stewardship or overseeing functions and the permanent establishment or fixed base is entitled to claim the employee's remuneration as a deduction in computing taxable income for United States purposes because the remuneration is definitely related and allocable to its gross income or a class of its gross income pursuant to Code section 861 and the regulations thereunder.

Paragraph (3) provides that, notwithstanding the provisions of paragraphs (2) and (3), remuneration derived by an employee (even if a resident of a State other than a Contracting State) of a resident of one Contracting State for labor or personal services performed as a member of the regular complement of a ship or aircraft operated in international traffic by a resident of that Contracting State may be taxed only by that Contracting State.

Article 17. ARTISTES AND ATHLETES

This Article deals with the taxation of income derived by public entertainers and athletes (sometimes referred to as "artistes and athletes") in respect of the performance of services as such in a Contracting State. The Article applies in cases where an artiste or athlete performs services on his own behalf and in cases where services are performed on behalf of another person, as an employee or pursuant to any other arrangement.

Paragraph (1) states the general rule that notwithstanding the provisions of Articles 15 (Independent Personal Services) and 16 (Dependent Personal Services), income derived by public entertainers such as theater, motion picture, radio, or television artistes, and musicians, and by athletes, from their personal activities as such, may be taxed in the Contracting State where those activities are exercised. Such income, however, is taxable under this Article only where it exceeds $100 or its equivalent in Philippine pesos per day or exceeds in the aggregate $3,000 or its equivalent in Philippine pesos during the taxable year.

As noted above, this paragraph overrides the provisions of Articles 15 and 16, so that an artiste or athlete may be taxed in the State where his activities take place regardless of the period of time he is present in that State. Generally, however, income derived from services rendered by producers, directors, technicians and others who are not artistes and athletes is taxable in accordance with the provisions of Article 15 or 16, as the case may be.

Paragraph (2) deals with cases where income in respect of the activities of an entertainer or athlete accrues to a person other than, or in addition to, the entertainer or athlete. It is based on paragraph (2) of Article 17 (Artistes and Athletes) of the OECD Model Convention and a counterpart is found in recent United States conventions with the United

Kingdom, Japan, Trinidad and Tobago, and Iceland. A common method employed by foreign entertainers is to perform services in the United States as an employee of or a contractor for a corporation or other person. That person may act as the nominal recipient of the income in respect of the entertainer's services and the entertainer may act as its "employee" or "contractor." In such cases, the corporation may escape taxation in respect of those services by reason of Article 8 (Business Profits) because it does not have a permanent establishment in the United States described under Article 5 (Permanent Establishment). The entertainer may also escape taxation by receiving a small salary while in the United States and by receiving payment in a later year when the income is subject to reduced rates of tax or no tax at all, or by liquidating the corporation after the services are performed.

Paragraph (2) is designed to deal with these situations by providing that where income in respect of the personal activities of an artiste or athlete accrues to the benefit of another person (including a corporation, trust, or partnership of either Contracting State or any third State), that income may, notwithstanding the provisions of Articles 8 (Business Profits), 15 (Independent Personal Services), and 16 (Dependent Personal Services), be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised. Thus, for example, such other person could not claim the permanent establishment protection provided by Articles 5 (Permanent Establishment) and 8 (Business Profits).

For purposes of paragraph (2), income is considered to accrue to the benefit of another person where that other person has control over or the right to gross income derived in respect of an entertainer's or athlete's services as such. This rule applies regardless of whether the other person is a "sham" corporation or conduit. However, income will not be deemed to accrue to the benefit of another person where it is established to the satisfaction of the competent authority of the Contracting State where the services are performed that neither the entertainer or athlete, nor persons related thereto, participate directly or indirectly in the profits of such other person or receive any benefit from such profits. Persons may be considered to be related to the artiste or athlete regardless of whether the persons are considered to be related under the provisions of paragraph (3) of Article 10 (Related Persons). For this purpose, a person may be considered to be related to the artiste or athlete if he is an employee or agent of the artiste or athlete, or if he is regularly employed by the artiste or athlete in an advisory capacity, such as his attorney, accountant, or investment advisor. An artiste or athlete will be considered to participate in the profits of the other person if he received, or is entitled to receive, deferred compensation, bonuses, fees, dividends, partnership or other distributions from that person or the proceeds from the sale or disposition of an interest in that person during the year in which services are performed, or in any subsequent year.

Paragraph (3) provides that, notwithstanding the provisions of paragraph (1) and Articles 15 (Independent Personal Services) and 16 (Dependent Personal Services), income derived from activities performed in a Contracting State by public entertainers or athletes will be exempt from tax in that Contracting State if the visit to that State is substantially supported or sponsored by the other Contracting State and the public entertainer or athlete is certified as qualified under this provision by the competent authority of the sending State. Under this provision, for example, Philippine folk dance troupe performers would be exempt from tax in the United States if their visit is substantially supported or sponsored by the Philippine Government and the Secretary of Finance of the Philippines or his delegate certifies those performers as qualified for exemption.

Article 18. PRIVATE PENSIONS AND ANNUITIES

Except as provided in Article 20 (Governmental Functions), pensions and other similar remuneration paid to an individual will be taxable under paragraph (1) only in the Contracting State where the service is rendered. Thus, private pensions and similar remuneration derived from sources within one Contracting State by an individual resident of the other Contracting State may be taxed in the first-mentioned Contracting State. The term "pensions and other similar remuneration" is defined in paragraph (4) to include any periodic payments, other than payments covered in Article 19 (Social Security Payments), made by reason of retirement or death and in consideration for services rendered, or by way of compensation for injuries or sickness received in connection with past employment. Thus, where payments are considered to be pensions or similar remuneration under the laws of one of the Contracting States, such payments will be considered to be pensions or similar remuneration for purposes of paragraph (1), subject to an agreement to the contrary by the competent authorities acting under paragraph (2) of Article 2 (General Definitions) to prevent double taxation or to further any other purpose of the Convention. Thus, for example, for United States tax purposes, distributions from independent retirement accounts would be considered to be pensions or similar remuneration to which paragraph (1) applies. On the other hand, the term pension does not include, for United States tax purposes, payments in respect of the cancellation or premature termination of employment contracts (e.g., "golden handshakes" or severance pay). Such payments are taxable under the provisions of Articles 15 (Independent Personal Services), 16 (Dependent Personal Services) or 17 (Artistes and Athletes).

Paragraph (2) provides that annuities paid to an individual resident of a Contracting State will be taxable only in that Contracting State. The term "annuities" is defined in paragraph (5) as a stated sum paid periodically at stated times during life, or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than for services rendered).

Paragraph (3) provides that child support payments made by an individual resident of one Contracting State to an individual resident of the other Contracting State will be exempt from tax in that other Contracting State. The term "child support payments" is defined in paragraph (6) as periodic payments for the support of a minor child made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support.

This Article is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Therefore, individuals who are citizens or residents of a Contracting State may be taxed by that Contracting State without regard to this Article.

Article 19. SOCIAL SECURITY PAYMENTS

This Article provides that social security payments and other public pensions, e.g., railroad retirement benefits, paid by one Contracting State to an individual who is a resident of the other Contracting State (or, in the case of such payments by the Philippines, to an individual who is a citizen of the United States) will be taxable only in the first-mentioned Contracting State. Payments described in Article 20 (Governmental Functions) are not covered by this Article.

Article 20. GOVERNMENTAL FUNCTIONS

Under this Article, wages, salaries, and similar remuneration, including pensions, annuities, or similar benefits, paid from public funds of one Contracting State to a citizen of that Contracting State, or to a citizen of a State other than a Contracting State who comes to the other Contracting State expressly for the purpose of being employed by the first-mentioned Contracting State, for labor or personal services performed as an employee of the national government of that Contracting State, or any agency thereof, in the discharge of functions of a governmental nature will be exempt from tax by the other Contracting State. If the individual becomes a citizen of, or acquires immigrant status in, the other Contracting State, that other Contracting State may tax the individual without regard to this Article. See paragraphs (3) and (4)(b) of Article 6 (General Rules of Taxation). Remuneration or pensions paid in respect of services rendered in connection with any trade or business carried on by one of the Contracting States or any agency thereof will be treated the same as compensation received from a private employer, and the provisions of Articles 15 (Independent Personal Services), 16 (Dependent Personal Services) and 18 (Private Pensions and Annuities), as the case may be, will apply.

This Article applies only to remuneration paid out of public funds by the national government of a Contracting State or its agencies.

Article 21. TEACHERS

Paragraph (1) provides that, if a resident of one Contracting State is invited by the other Contracting State, a political subdivision or local authority thereof, or by a university or other recognized educational institution in that other Contracting State to come to the other Contracting State for a period not expected to exceed 2 years for the purpose of teaching or engaging in research, or both, at a university or other recognized educational institution, and if such resident comes to that other Contracting State primarily for such purpose, his income from personal services for teaching or research at such university or educational institution will be exempt from tax by that other Contracting State for a period not exceeding 2 years from the date of his arrival in that other Contracting State.

Since a temporary visit may be of such a duration that an individual may lose his status as a resident of the Contracting State of which he was a resident at the time he became eligible for the benefits of this Article, the individual need only be a resident of such Contracting State at the beginning of his visit. However, if the individual becomes a citizen of, or acquires immigrant status in, the other Contracting State, that other Contracting State may tax the individual without regard to this Article. See paragraphs (3) and (4)(b) of Article 6 (General Rules of Taxation). If the individual's visit exceeds a period of 2 years from the date of his arrival, the exemption applies only to the income received by the individual before the expiration of such 2-year period. However, if the period of the visit had been expected to exceed two years then the exemption does not apply to any of the income earned. However, if an individual who otherwise meets the requirements of this Article expects to visit for a period of two years for the purpose of teaching and for a subsequent period of, for example, two years for purposes described in paragraph (1) of Article 22 (Students and Trainees), then pursuant to paragraph (4) of Article 22 the exemption provided by this Article does apply.

A person who visits a Contracting State for the purposes explained in this Article and meets the qualifications contained in it may again claim its benefits if he first reestablishes his residence in the other Contracting State. In such a case, the person claiming these benefits on a subsequent occasion must first satisfy the competent authority of the first-mentioned Contracting State that he had become a bona fide resident of the other Contracting State for a substantial period of time.

Pursuant to paragraph (2), this Article does not apply to income from research undertaken not in the general interest (i.e., public interest) but primarily for the private benefit of a specific person or persons other than the person performing the research. For example, research projects which are undertaken to discover or perfect product processes, designs, etc., which are expected to be commercially exploited by the researcher or his present (or former) employer do not qualify under this Article.

Article 22. STUDENTS AND TRAINEES

Paragraph (1) provides that an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein for the primary purpose of studying at a university or other recognized educational institution, securing training required to qualify him to practice a profession or professional specialty, or studying or doing research as a recipient of a grant, allowance, or award from a governmental, religious, charitable, scientific, literary, or educational organization, will be exempt from tax by that other Contracting State, with respect to certain amounts, for a period not exceeding 5 taxable years from the date of his arrival in that other Contracting State. The amounts exempted under this provision are gifts from abroad for the purpose of his maintenance, education, study, research or training; the grant, allowance, or award; and, income from personal services performed in the other Contracting State not in excess of $3,000 (or its equivalent in Philippine pesos) for any taxable year. For United States tax purposes, gifts will be considered to be from abroad when they are borne by a person who is not a resident (as defined in Article 3 (Fiscal Domicile)) of the United States.

Under paragraph (2), an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein as an employee of, or under contract with, a resident of the first-mentioned Contracting State, for the primary purpose of acquiring technical, professional, or business experience from a person other than that resident of the first-mentioned Contracting State or other than a person related to such resident, or studying at a university or other recognized educational institution in that other Contracting State, will be exempt from tax by that other Contracting State for a period not exceeding 12 consecutive months, on income from personal services not in excess of $7,500 or its equivalent in Philippine pesos for any taxable year.

Under paragraph (3), an individual who is a resident of one Contracting State at the time he becomes temporariliy present in the other Contracting State and who is temporarily present therein for a period not exceeding 1 year, as a participant in a program sponsored by the government of the other Contracting State, for the primary purpose of training, research, or study, will be exempt from tax by the other Contracting State with respect to his income from personal services in respect of such training, research, or study performed in that other Contracting State in an aggregate amount not in excess of $10,000 or its equivalent in Philippine pesos for any taxable year.

The monetary limits provided in paragraphs (1), (2), or (3) are in addition to, and not in lieu of, other exemptions provided by the Code. Thus, an unmarried resident of the Philippines who is temporarily present in the United States for the primary purpose of studying at a university would be entitled to exclude $3,000 of income from the performance of personal services (if he is present in the United States for periods totaling less than 90 days during the taxable year) and, in addition, would be entitled to the personal exemption allowed by section 151 of the Code, as provided in section 873(b) of the Code.

In comparison to paragraph (2)(c) of Article 15 (Independent Personal Services), which provides that the competent authorities may agree in an exchange of letters to a monetary limitation in excess of $10,000 or its equivalent in Philippine pesos, the monetary limitations of paragraphs (1), (2), and (3) cannot be increased by means of an exchange of letters between the competent authorities.

The first sentence of paragraph (4) provides that the benefits provided in paragraph (1) for certain students, trainees and researchers and the benefits provided under Article 21 (Teachers), when taken together, may extend only for such period of time, not to exceed 5 taxable years from the date of the individual's arrival, as may reasonably or customarily be required to effectuate the purpose of the visit. The second sentence of paragraph (4) makes it clear that the benefits provided by Article 21 (Teachers) will not be available to an individual if, during the immediately preceding period, the individual enjoyed the benefits provided by paragraph (1). Thus, a Philippine individual who originally entered the United States for the purpose of becoming a student and received benefits under paragraph (1) must leave the United States and reestablish residence in the Philippines before he can obtain the benefits of Article 21. In such a case, the person claiming the benefits of Article 21 on a subsequent occasion must first satisfy the competent authority of the United States that he had become a bona fide resident of the Philippines for a substantial period of time. In addition, the individual must, of course, meet the requirements of paragraph (1) of Article 21, viz., he must return at the invitation of the United States, a political subdivision or local authority thereof, or a university or other recognized educational institution for the primary purpose of becoming a teacher, etc.

If an individual qualifies for the benefits of more than one of the provisions of this Article, such individual may choose the most favorable provision but may not claim the benefits of more than one provision in any taxable year as a means of avoiding the limitation provided. Thus, for example, an individual who comes to the other Contracting State for the primary purpose of studying may be able to qualify under either paragraph (2) or (3) of this Article. However, he cannot combine the maximum exclusion limits in those two paragraphs to exclude $17,500 during the taxable year. If the individual becomes a citizen of, or acquires immigrant status in, the other Contracting State, that other Contracting State may tax the individual without regard to this Article. See paragraphs (3) and (4)(b) of Article 6 (General Rules of Taxation).

Article 23. RELIEF FROM DOUBLE TAXATION

In order to avoid double taxation, each Contracting State agrees in this Article to provide to its citizens or residents a credit against its taxes for taxes paid by such persons to the other Contracting State.

The United States agrees to allow a United States citizen or resident as a credit against United States tax the appropriate amount of taxes paid or accrued to the Philippines in accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle of paragraph (1)). In addition, in the case of a United States corporation owning at least 10 percent of the voting stock of a Philippine corporation from which it receives dividends in any taxable year, the United States will allow credit for the appropriate amount of taxes paid or accrued to the Philippines by the Philippine corporation paying such dividends with respect to the profits out of which such dividends are paid. The appropriate amount will be based upon the amount of tax paid or accrued to the Philippines but the credit is not to exceed the limitations (for the purpose of limiting the credit to the United States tax on income from sources within the Philippines or on income from sources outside of the United States) provided by United States law for the taxable year. This provision does not require the United States to provide a per-country or overall limitation in the future so long as the general principle of a foreign tax credit remains in effect. For the purpose of applying the United States credit in relation to taxes paid or accrued to the Philippines, the rules set forth in Article 4 (Source of Income) will be applied to determine the source of income, and the taxes referred to in paragraphs (1)(b) and (2) of Article 1 (Taxes Covered) will be considered to be income taxes.

Paragraph (2) provides the general rule that the Philippines will allow a Philippine citizen or resident as a credit against Philippine tax the appropriate amount of income taxes paid or accrued to the United States and, in the case of a Philippine corporation owning at least 50 percent of the voting stock of a United States corporation from which it receives dividends in any taxable year, will also allow credit for the appropriate amount of taxes paid or accrued to the United States by the United States corporation paying such dividends with respect to the profits out of which such dividends are paid. The appropriate amount will be based upon the amount of tax paid or accrued to the United States but will not exceed the limitations (for the purpose of limiting the credit to the Philippine tax on income from sources within the United States and on income from sources outside the Philippines) provided by Philippine law for the taxable year. Under section 30(c)(4) of the Philippine Code, the Philippine foreign tax credit is subject to both the per-country and overall limitations. Of course, the Philippines are not obligated to retain such limitations as long as the principle of a foreign tax credit is retained. For the purpose of applying the Philippine credit in relation to taxes paid or accrued to the United States, the rules set forth in Article 4 (Source of Income) will be applied to determine the source of income and the taxes referred to in paragraphs (1)(a) and (2) of Article 1 (Taxes Covered) will be considered to be income taxes.

The general rule of paragraph (2), that citizens of the Philippines will be given a credit against Philippine tax for income taxes paid or accrued to the United States, is subject to an exception contained in an Exchange of Notes between the Governments of the Philippines and the United States dated November 24, 1976. In that Exchange of Notes, it was agreed that so long as the Philippine Government taxes the worldwide income of Philippine citizens residing outside the Philippines at reduced rates of 1, 2, or 3 percent, the Philippine Government may give a deduction rather than a credit to those citizens for U.S. taxes paid. It was also agreed that in the event that those rates are increased, Article 23 would require the Philippine Government to grant their nonresident citizens a foreign tax credit for U.S. taxes.

Article 24. NONDISCRIMINATION

This Article sets forth the general rules prohibiting discriminatory taxation of residents and corporations of one Contracting State by the other Contracting State. It also reserves to the Philippines the right to limit to its citizens or corporations certain tax incentives in carefully limited circumstances described in currently existing Philippine law.

Paragraph (1) provides that a citizen of one Contracting State who is a resident of the other Contracting State will not be subject in that other Contracting State to more burdensome taxes than a citizen of that other Contracting State who is a resident thereof. The determination of whether more burdensome taxation exists is to be made by comparing the treatment of individuals who are in comparable positions. Thus, for example, a citizen of the Philippines who is a resident of the United States and who otherwise meets the requirements specified in section 911 of the Code would, under this Article, be eligible for the benefits of section 911 even though not a citizen of the United States. On the other hand, just as a United States citizen who becomes a nonresident alien at any time during a taxable year or whose spouse is a nonresident alien at any time during a taxable year cannot file a joint return for that year, a Philippine citizen would not be entitled to file a joint return with his spouse if either is a nonresident alien at any time during the taxable year and the election provided in section 6013(g) of the Code has not been made.

Paragraph (2) provides that a permanent establishment which a resident of one Contracting State has in the other Contracting State will not be subject in that other Contracting State to more burdensome taxes than a resident of that other Contracting State carrying on the same activities. However, this does not obligate a Contracting State to grant to individual residents of the other Contracting State any personal allowances, reliefs, or deductions for taxation purposes on account of civil status or family responsibility which it grants its own individual residents.

Paragraph (3) prohibits one Contracting State from subjecting a corporation of such Contracting State the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State to any taxation or any requirement connected with taxation which is other or more burdensome than those applicable to corporations of the first-mentioned Contracting State carrying on the same activities, the capital of which is wholly or partly owned or controlled by one or more residents of the first-mentioned Contracting State.

Under paragraph (4), the term "taxes" or "taxation" means, for purposes of this Article, taxes or taxation of every kind imposed at the national, state or local level, notwithstanding any other provision of the Convention. However, for other purposes of the Convention, the term "tax" means tax imposed by the United States or the Philippines to which the Convention applies. See paragraph (1)(g) of Article 2 (General Definitions).

Paragraphs (5) and (6) are exceptions to the general rules set forth in paragraphs (1), (2), and (3). Paragraph (5) provides that, with respect to the income tax imposed under Title II of the Philippine Code, nothing in paragraphs (1), (2), and (3) will prevent the Philippines from limiting to its citizens or corporations the enjoyment of tax incentives granted under the following three provisions of Philippine law: section 6 of the Investment Incentives Act (Republic Act No. 5186); sections 5 and 7(b) of the Export Incentives Act (Republic Act No. 6135); and section 9 of the Investment Incentives Program for the Tourism Industry (Presidential Decree No. 535). However, only the incentives which were in force on and have not been modified since Ocrober 1, 1976, the date of signature of the Convention, or have been modified only in minor respects so as not to affect their general character, may be limited to Philippine citizens or corporations.

The policy of the Investment Incentives Act, as expressed in section 2 thereof, is the acceleration of the sound development of the Philippine economy in consonance with the principles and objectives of economic nationalism.

The Investment Incentives Act, the Export Incentives Act, and the Investment Incentives Program for the Tourism Industry represent a broad Philippine program to develop specific areas of the Philippine economy without relinquishing Philippine control thereover. Under that program, certain Philippine corporations can register with the Philippine Board of Investments, and become registered enterprises. To register, generally, 60 percent of a Philippine corporation's voting stock must be owned and controlled by Philippine nationals. If a registered enterprise is engaged in specified preferred economic areas of investment or becomes a pioneer enterprise, the corporation and its investors, both foreign and Philippine, are entitled to specified economic or tax incentives which are not otherwise granted by Philippine internal law. A pioneer enterprise is a registered enterprise that is engaged in the manufacture, processing, or production of goods, products, or raw materials that are not being produced in the Philippines on a commercial scale or is a registered enterprise which uses a design, formula, scheme, method, process, or system of production or transformation which is new or untried in the Philippines and which involves the substantial use and processing of Philippine raw materials.

The incentives granted under the provisions referred to in paragraph (5) are limited, with one exception which relates to certain Philippine corporations, to Philippine nationals. A Philippine national is a Philippine citizen, a partnership or association wholly owned by Philippine citizens, a Philippine corporation of which at least 60 percent of the outstanding voting shares are owned and held by Philippine citizens, or trustees of certain pension trusts benefitting Philippine nationals.

The following three incentives are granted by section 6 of the Investment Incentives Act to Philippine nationals who invest in pioneer enterprises. First, Philippine nationals are allowed a deduction from their taxable income (which cannot exceed 10 percent of taxable income) for an investment of cash or property made in the form of an acquisition of shares in the original or increased capital stock of a pioneer enterprise. A deduction is allowed only if the investment is made within 7 years from the date of the corporation's registration and the shares are held for a period of not less than 3 years. In addition, Philippine nationals are granted an exemption from Philippine income tax for capital gains which are invested in new issues of capital stock of, or in the purchase of stock owned by foreigners in, pioneer enterprises. However, the investment must be made within 6 months from the date of realization of the gain and the stock must not be disposed of for 3 years. Finally, gain realized by Philippine nationals upon the disposition of stock dividends received from pioneer enterprises are exempt from tax, provided such disposition occurs within 7 years from the date of registration of the enterprise. Section 5 of the Export Incentives Act grants the same three incentives to Philippine nationals for investment in registered export producers that are pioneer enterprises. Section 9 of the Investment Incentives Program for the Tourism Industry grants only two of those incentives--the deduction for investment and the capital gains exemption--to Philippine nationals who invest in registered tourism enterprises.

Section 7(b) of the Export Incentives Act differs from the above described tax incentives in that it applies to the export producer rather than the investor therein. Under that section, a registered export producer which is a Philippine citizen or a Philippine corporation of which 60 percent of its capital is owned and controlled by Philippine citizens is entitled to a deduction from taxable income in an amount equivalent to the sum of the direct labor cost and local raw materials used in the manufacture of export products. That deduction may only be claimed during the 5-year period beginning on the date of its registration and cannot exceed 25 percent of the registered export producer's taxable income.

Other tax incentives found in the above described acts or the presidential decree or in other acts or decrees which result in more burdensome taxation for United States persons resident in the Philippines, or Philippine corporations partly or wholly owned or controlled directly or indirectly by United States residents are subject to the general rules of paragraphs (1), (2), and (3). Thus, United States citizens will be eligible for these incentives.

Paragraph (6) provides that, with respect to taxes other than the income tax imposed under Title II of the Philippine Code, nothing in the first three paragraphs will prevent the Philippines or a political subdivision or local authority thereof from limiting to Philippine citizens or corporations the enjoyment of tax incentives for the promotion of industry or business, similar to those discussed above in connection with paragraph (5). However, only the incentives which were in force on, and have not been modified since October 1, 1976, the date of signature of the Convention, or have been modified only in minor respects so as not to affect their general character, may be limited to Phillipine citizens or corporations.

A final exception to the general rules of paragraphs (1), (2), and (3) relates to the taxation of income derived from the operation of ships and aircraft in international traffic. See the discussion of Article 9 (Shipping and Air Transport), supra.

Article 25. MUTUAL AGREEMENT PROCEDURE

Under paragraph (1), when a resident or citizen of one Contracting State considers that action of one or both Contracting States results or will result for him in taxation not in accordance with the Convention, he may, notwithstanding the remedies provided by the national laws of the Contracting States, present his case to the competent authority of the Contracting State of which he is a resident or citizen. A resident or citizen of a Contracting State need not, although it is anticipated that in the normal situation he will, exhaust his other administrative or judicial remedies prior to resorting to the use of the mutual agreement procedure. If the claim is considered to have merit by the competent authority, that competent authority will endeavor to come to an agreement with the competent authority of the other Contracting State with a view to the avoidance of taxation not in accordance with the Convention.

Paragraph (2) requires the competent authorities of the two Contracting States to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the application of the Convention. In particular, the competent authorities may agree to the same attribution of business profits to a resident of one Contracting State and its permanent establishment situated in the other Contracting State; the same allocation of income, deductions, credits, or allowances between a resident of one Contracting State and a related person and to the readjustment of taxes imposed by each Contracting State to reflect such allocation; the same determination of the source of particular items of income; and, the same characterization of particular items of income.

Under paragraph (3), in implementing the provisions of this Article, the competent authorities may communicate with each other directly and, when advisable, meet together for an oral exchange of opinions.

Under paragraph (4), in cases in which the competent authorities reach an agreement, taxes will be imposed on such income and refund or credit of taxes will be allowed by the Contracting States in accordance with such agreement. In the case of the United States, where an agreement is reached between the competent authorities which requires the United States to make a refund of tax or to extend any other similar credit, such refund or credit will be allowed, notwithstanding procedural barriers otherwise existing under United States law, such as the statute of limitations. In cases where an agreement cannot be reached between the two competent authorities, the United States will not be required to provide any relief for double taxation on a unilateral basis. Paragraph (4), of course, does not authorize the imposition of additional taxes after the statute of limitations has run.

In the case of the Philippines, a refund or credit will also be allowed, but such refund or credit will be subject to Philippine procedural rules (including the statute of limitations). This permits the Philippines to disallow a claim for refund or credit on the basis of section 309 of the Philippine Code, if that claim is filed later than 2 years from the payment of the tax. However, the Philippines will issue a tax credit certificate, notwithstanding any Philippine procedural rule, such as section 309 of the Philippine Code, if a claim is filed with the competent authority of the Philippines no later than 2 years from the close of the Philippine taxable year in which the United States tax imposed under paragraph (4) is paid. The amount of the tax credit certificate will be computed in the same manner as if an actual refund had been made. It may be used only as a credit against Philippine tax liability and will not give rise to a refund.

When the Philippine tax credit certificate is used by a taxpayer to offset its Philippine tax liability, there is an adjustment in Philippine taxes for U. S. tax credit purposes: the Philippine taxes paid by that taxpayer for the year (or years) with respect to which the certificate was issued are reduced to the extent that the credit authorized in the certificate is used to offset its Philippine taxes in another year (or years). Consequently, for U. S. tax credit purposes, there is no reduction in the taxpayer's Philippine taxes for the year (or years) with respect to which the certificate is used as a credit against its Philippine taxes.

Because books of accounts and other accounting records must be preserved, under section 337 of the Philippine Code, for a period of at least 5 years from the date of the last entry in each book, it is anticipated that the competent authority of the Philippines will have at his disposal sufficient information to come to an agreement with the competent authority of the United States so that taxation not in accordance with the provisions of the Convention will be avoided. Thus, if a claim for a tax credit certificate is filed within 5 taxable years from the close of the Philippine taxable years in issue, the competent authorities of both Contracting States will communicate or meet and, if agreement is reached, the tax credit certificate will be issued. However, if a claim is filed after the aforementioned 5-taxable year period, the competent authority of the Philippines may not have sufficient information at his disposal to come to an agreement with the competent authority of the United States if the Philippine taxpayer did not preserve its books of accounts or other accounting records for longer than the 5-year minimum period. To facilitate the agreement process between the competent authorities of the two Contracting States, paragraph (4) provides that a tax credit certificate will be issued with respect to a claim filed after the 5-taxable year period beginning with the close of the Philippine taxable year in issue only if the claim is supported by the books and records of the taxpayer.

Article 26. EXCHANGE OF INFORMATION

Paragraph (1) provides for a system of administrative cooperation between the competent authorities of the two Contracting States by requiring an exchange of information necessary for the carrying out of the Convention and of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is in accordance with the Convention. The competent authorities may exchange information in connection with tax compliance generally, not merely illegal acts or crimes. Information need be exchanged, however, only if it is of a class that can be obtained under the laws and administrative practices of each Contracting State with respect to its own taxes.

Paragraph (2) provides that information exchanged must be treated as secret. However, such information may be disclosed to any persons or authorities concerned with or made part of the public record with respect to the assessment, collection, or enforcement of, or litigation with respect to, the taxes which are the subject of the Convention. Thus, disclosure is not prohibited as a part of a public proceeding before a court or an administrative body.

Paragraph (3) provides that no information may be exchanged which would be contrary to public policy.

Paragraph (4) provides that if information is requested by a Contracting State in accordance with Article 26, the other Contracting State will obtain the information to which the request relates from or with respect to its residents or with respect to its residents or corporations in the same manner and to the same extent as if the tax of the requesting State were the tax of the other State and were being imposed by the other State.

A Contracting State may obtain information from or with respect to its residents or corporations in accordance with paragraph (4) for the sole purpose of assisting the other Contracting State in the determination of the taxes of that other State. Thus, a Contracting State may use the mechanisms provided by its internal law to obtain information for the other Contracting State even if it has no internal tax interest in obtaining that information; its only interest being the request made under paragraph (4).

Paragraph (5) provides that depositions of witnesses and copies of unedited original documents (including books, papers, statements, records, accounts, or writings) may be provided by the competent authority of a Contracting State if specifically requested by the competent authority of the other Contracting State to the extent such depositions and documents can be obtained under the laws and administrative practices of each Contracting State with respect to its own taxes.

Paragraph (6) provides that the exchange of information may be on either a routine basis or on request with reference to particular cases, and that the competent authorities may agree on the list of information to be furnished on a routine basis.

Article 27. ASSISTANCE IN COLLECTION

Paragraph (1) provides that one Contracting State will give the other Contracting State limited assistance in collecting its taxes. Thus, each Contracting State is required to collect on behalf of the other Contracting State only those taxes imposed by such other Contracting State as will ensure that any exemption or reduced rate of tax granted under this Convention by such other Contracting State is not enjoyed by persons not entitled to such benefits.

Paragraph (2) makes clear that a Contracting State is not obligated to carry out measures at variance with the laws or the administrative practice of either Contracting State with respect to the collection of its own taxes.

Article 28. DIPLOMATIC AND CONSULAR OFFICERS

This Article provides that nothing in the Convention will affect the fiscal privileges of diplomatic and consular officials under the general rules of international law or under the provisions of special agreements. This is merely a special case of the general rule provided in paragraph (2) of Article 6 (General Rules of Taxation).

Article 29. ENTRY INTO FORCE

Paragraph (1) provides that the Convention is subject to ratification and provides for the exchange of instruments of ratification. The Convention will enter into force 30 days after the date of exchange of such instruments of ratification. The Convention shall first have effect as respects the rate of withholding of tax, to amounts paid on or after January 1 of the year following the date on which the Convention enters into force and, as respects other taxes, to taxable years beginning on or after January 1 of the year following the date on which the Convention enters into force. However, paragraph (2) provides an exception to those effective dates. Under paragraph (2)(b)(iii) of Article 13 (Royalties), the tax imposed by the Philippines on royalties derived by residents of the United States is limited to an amount that does not exceed the lowest rate of Philippine tax that may be imposed on royalties of the same kind paid under similar circumstances to a resident of a third State. That provision will not have effect before January 1, 1979, with respect to payments received as consideration for the use of, or the right to use, a copyright of cinematographic films or films or tapes used for radio or television broadcasting.

Article 30. TERMINATION

Article 30 provides that the Convention will continue in force indefinitely, but that it may be terminated by either Contracting State at any time after 5 years from the date it enters into force. A Contracting State seeking to terminate the Convention must give at least 6 months' prior notice through diplomatic channels. If the Convention is terminated, such termination will be effective with respect to income of calendar years or taxable years beginning (or, in the cases of taxes payable at source, payments made) on or after January 1 next following the expiration of the 6-month period. It is intended that the reference to calendar years applies only to cases where the taxable year is the calendar year.

TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND THE FEDERAL REPUBLIC OF GERMANY FOR THE AVOIDANCE OF DOUBLE TAXATION WITH RESPECT TO TAXES ON ESTATES, INHERITANCES, AND GIFTS SIGNED AT BONN ON DECEMBER 3, 1980

Introduction

This is a technical explanation of the estate and gift tax Convention between the United States and the Federal Republic of Germany signed on December 3, 1980 ("the Convention"). This explanation is an official guide to the Convention. It reflects policies behind particular Convention provisions, as well as understandings reached with respect to the interpretation and application of the Convention.

The proposed estate and gift tax Convention with the Federal Republic of Germany would be the first of its kind between the two countries. It would apply, in the United States, to the Federal estate tax and the Federal gift tax, including the tax on generation-skipping transfers and, in the Federal Republic of Germany, to the inheritance and gift tax.

The proposed Convention with the Federal Republic of Germany is similar in principle to the United States estate and gift tax Convention with the United Kingdom, which entered into force November 11, 1979, and to the estate and gift tax Convention with France, which entered into force October 1, 1980. It is also similar to the U.S. model estate and gift tax Convention, published by the Treasury Department on December 8, 1980. The details of some provisions in the proposed Convention, however, differ from those in either the United Kingdom or French Conventions or the model.

The general principle of the proposed Convention with the Federal Republic of Germany is that the country of domicile may tax the estate or gifts of a decedent or donor on a worldwide basis, but must credit tax paid to the other State with respect to certain types of property located therein. Specifically, immovable property, certain business assets, and partnership interests attributable to such property are taxable in the Contracting State where situated. The Convention also contains a "saving" clause which allows the United States to tax estates and gifts of its citizens and the Federal Republic of Germany to tax heirs, donees, or other beneficiaries domiciled in the Federal Republic of Germany, provided a credit is given for tax paid to the other State on either a domiciliary or situs basis.

The Convention provides rules for determining which State has the right to tax on a worldwide basis in the case of a decedent or donor who is domiciled in both Contracting States at the time of death or gift. It provides that a United States citizen who is domiciled in both the United States and the Federal Republic of Germany shall be deemed to be domiciled in the United States if he had not been domiciled in the Federal Republic of Germany for more than 5 years. The effect of this rule is that the Federal Republic of Germany may not subject the estate or gifts of a U.S. citizen and domiciliary to tax on a worldwide basis if he has been domiciled in the Federal Republic of Germany for 5 years or less. Where the 5-year rule does not apply, the Convention provides a set of reciprocal rules for resolving the issue of domicile.

The Convention provides that inter-spousal transfers may be taxed by a Contracting State on a situs basis only to the extent they exceed 50 percent of all taxable transfers. In the case of the United States, the reduction in tax is limited to the tax that would be due if the normal citizen or resident rates were applied to the tax base. In the case of the Federal Republic of Germany, the marital relief may not result in an exclusion from the taxable base in excess of the general marital deduction available to those subject to unlimited German tax liability.

With respect to estates and trusts, the Convention does not preclude a Contracting State from applying its rules governing the recognition of a taxable event. The competent authorities may discuss, and attempt to resolve, problems arising due to the differences in the timing of taxable events, provided the differences do not exceed 5 years. The beneficiary of an estate or trust may elect to be subject to all German taxation within the 5 year period in order to be eligible for competent authority relief.

The Convention does not have a Non-discrimination Article. This is because the existing income tax treaty between the United States and the Federal Republic of Germany has such an Article, which applies to all taxes including estate and gift taxes.

The Convention is subject to ratification. Once ratified, it will enter into force immediately upon the exchange of instruments of ratification and its provisions shall apply to estates of persons dying and gifts made on or after January 1, 1979. In the case of estates of persons dying between January 1, 1974 and January 1, 1979, the competent authorities may consult for the purpose of eliminating double taxation.

The Convention shall remain in force indefinitely unless terminated by one of the Contracting States. It may be terminated by six months diplomatic notice after three years from its entry into force.

Article 1. SCOPE

This article defines the coverage of the Convention. It provides that the Convention applies to estates of deceased persons and gifts of donors whose domicile was in one or both of the Contracting States at the time of death or the making of a gift. According to Article 2 (Taxes Covered), the Convention applies, in the United States, to the Federal tax on generation-skipping transfers. Thus, the Convention also applies to generation-skipping transfers by deemed transferor's domiciled in one or both of the Contracting States. Under paragraph 1 of Article 4 (Fiscal Domicile), domicile is determined initially under the domestic law of each Contracting State. According to that paragraph, an individual is domiciled in the United States if he is a resident or citizen of the United States. (See the explanation of Article 4 (Fiscal Domicile) for a discussion of the residence concept for purposes of United States estate and gift taxation). Thus, the Convention applies to a U.S. citizen residing in a third State and owning shares of stock in a German corporation. In general, Article 4 (Fiscal Domicile) contains detailed rules for determining a single State of domicile for purposes of the Convention in cases where the domestic laws of each Contracting State would consider an individual to be a domiciliary.

Article 2. TAXES COVERED

Paragraph 1 identifies the taxes existing at the time of signature and which are covered by the Convention. With respect to the United States, the Convention applies to the Federal estate tax, the Federal gift tax, and the Federal tax on generation-skipping transfers. A generation-skipping transfer involves the splitting of benefits between generations younger than the generation of the transferor or grantor. If, for example, A transfers property to B for 10 years or for B's life, and after 10 years or upon B's death the property passes to C, and B and C are in younger generations than A, but different generations from each other, the United States will impose an estate or gift tax on the transfer from A and a generation-skipping tax on the transfer from B. The generation-skipping tax is substantially equivalent to the amount of estate or gift tax that would be due if the property interest had been transferred outright from each generation to the next.

The Federal estate, gift, and generation-skipping transfer taxes actually are imposed on the transfer of property by death, gift, and generation-skipping transfer, respectively. Thus, while Article 1 (Scope) states that the Convention applies to certain estates and gifts, it actually applies, in the United States, to the transfer of property by death, gift, and generation-skipping transfer. In the case of the Federal Republic of Germany, the Conventon applies to the inheritance and gift tax.

To avoid the necessity of concluding a new convention whenever the tax laws of the United States or the Federal Republic of Germany are modified, paragraph 2 provides that the Convention also applies to any substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes.

Article 3. GENERAL DEFINITIONS

Paragraph 1 defines the terms "United States of America," "Federal Republic of Germany," "enterprise," "enterprise of a Contracting State," and "competent authority." This paragraph does not, however, contain all the terms defined in the Convention. "Domicile," for example, is defined in Article 4 (Fiscal Domicile), "immovable property" is defined in Article 5 (Immovable Property), and "permanent establishment" is defined in Article 6 (Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for the Performance of Independent Personal Services). The term "United States of America," when used in a geographical sense, means the states thereof and the District of Columbia. Thus, the term does not include Puerto Rico, the Virgin Islands, Guam, or any other U.S. possession or territory. The term also includes the territorial sea and, in general accord with the principles of section 638 of the Code, the Continental Shelf of the United States.

Paragraph 2 provides that any term not otherwise defined in the Convention shall, unless the context otherwise requires, have the meaning which it has under the tax laws of the Contracting State whose tax is being determined. Paragraph 3 of Article 13 (Mutual Agreement Procedure) makes clear that the competent authorities of the Contracting States may agree on a common meaning of any term used in the Convention.

Article 4. FISCAL DOMICILE

This Article determines an individual's domicile for purposes of the Convention and establishes rules for resolving cases of dual domicile. The determination of a single domicile for purposes of the Convention is important since the State of domicile has the primary right to tax estates and gifts of property wherever located, except property covered by Article 5 (Immovable Property), 6 (Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for Performance of Independent Personal Service), or 8 (Interests in Partnerships). This primary right is not exclusive, however, because the saving clause of paragraph 1 of Article 11 (Credits) allows the United States to tax in all events on the basis of citizenship and allows the Federal Republic of Germany to tax heirs, donees, or other beneficiaries on the basis of domicile. The State taxing on the basis of the saving clause is required to credit tax imposed by the other State on a domiciliary or situs basis.

Under Paragraph 1, domicile is determined initially under the domestic law of each Contracting State. That law is taken as given; the Convention does not assess or modify the criteria used by a Contracting State for its determination of domicile. Subparagraph 1a) provides that an individual is domiciled in the United States, for purposes of the Convention, if he is a resident or citizen of the United States. For this purpose, a resident is an individual living in the United States who has the intention to remain in the United States indefinitely or an individual who has lived in the United States with such an intention and who has not formed the intention to remain indefinitely in another country. This may be contrasted with the use of the term "resident" for purposes of the Federal income tax; an alien present in the United States who is not a mere transient or sojourner is a resident of the United States for income tax purposes. Citizens are included in the definition of domiciliary for purposes of the Convention because the United States taxes its citizens, as well as its residents, on a worldwide basis, and nonresident U.S. citizens may encounter some of the same problems of double taxation that face U.S. residents.

Subparagraph 1b) provides that an individual is domiciled in the Federal Republic of Germany if he has a domicile or habitual abode in the Federal Republic of Germany or, if for other reasons, he is subject to unlimited tax liability under German inheritance and gift tax. German law defines domicile as the place where an individual maintains a residence under conditions that it will be used. The definition has two criteria: the existence of a residence and its use on a more than temporary basis. If the requirements of "domicile" are not met, an individual may be deemed to be a German domiciliary or resident if he has an habitual abode in Germany. According to German law, an habitual abode is "a place where one spends time in circumstances which indicate more than a temporary presence". In particular, wherever a stay in Germany exceeds six months, an habitual abode is considered to exist. Finally, German citizens with neither a domicile nor habitual abode in Germany are considered domiciliaries subject to unlimited German inheritance and gift tax liability, if they have had a domicile or habitual abode in Germany in the past five years.

Paragraph 2 provides rules for resolving cases where, under the domestic laws of the respective Contracting States, an individual is domiciled in both States. Under paragraph 2, a single domicile is determined according to the following sequential criteria: (a) the individual will be deemed to be domiciled in the Contracting State in which he maintained his permanent home; if he had a permanent home in both Contracting States, or in neither Contracting State, his domicile will be deemed to be in the Contracting State with which his personal and economic relations were closest (in other words, the State in which his center of vital interests was located); (b) if the Contracting State in which the individual's center of vital interests was located cannot be determined, his domicile will be deemed to be in the Contracting State in which he had an habitual abode; (c) if he had an habitual abode in both Contracting States, or in neither, his domicile will be deemed to be in the Contracting State of which he was a citizen; and (d) if he was a citizen of both Contracting States, or neither of them, the competent authorities of the Contracting States will settle the issue by mutual agreement. The determination of a center of vital interests for purposes of subparagraphs 2a) and 2b) is a relative test between the two Contracting States. Thus, the center of vital interests as between the United States and the Federal Republic of Germany may be identified, even if an individual has still closer personal and economic relations with a third State.

Paragraph 3 of the Convention contains an important exception to the tie-breaking rules of paragraph 2. It applies where an individual was: (a) a citizen of one, but not the other, Contracting State; (b) domiciled in both Contracting States according to the domestic laws of those States; and (c) domiciled in the Contracting State of which he was not a citizen for not more than 5 years. If all these conditions are met, the individual is deemed to be domiciled in the State of which he was a citizen. This rule restricts the right of the Federal Republic of Germany to tax the estate and gifts of a U.S. citizen who has been domiciled in the Federal Republic of Germany for 5 years or less to situs-basis taxation. Since this rule also applies to members of an individual's family forming part of his household and also fulfilling the requirements of subparagraphs 3a), 3b), and 3c), it also restricts the taxing rights of the Federal Republic of Germany as regards these individuals to situs-basis taxation. In particular, the Federal Republic of Germany would not be able to tax an individual on a domiciliary basis on property received from one's spouse, provided both spouses met the three tests of paragraph 3. The 5-year rule is based on the concept that a Contracting State should not tax the estate or gifts of an individual on a domiciliary basis if the individual has not been present in that State for a significant period of time. According to the Convention, a significant period of time is more than 5 years. This paragraph is reciprocal, comporting with the Federal Republic of Germany's statutory authority to tax citizens who emigrate on a domiciliary basis for a 5-year period. If the individual has been domiciled in the State of which he was not a citizen for more than 5 years, he is not necessarily deemed to be domiciled in that State for purposes of the Convention. Domicile would then be determined under the tie-breaking rules of paragraph 2.

Paragraph 4 provides that an individual who, at the time of death or the making of a gift, was a resident of a U.S. possesion and who became a U.S. citizen solely by reason of citizenship of, or birth or residence in, a possession, shall not be considered domiciled in or a citizen of the United States at that time for purposes of the Convention. This exclusion conforms with Sections 2209 and 2501(c) of the Internal Revenue Code. This paragraph does not apply to a former resident of a possession who acquired U.S. citizenship through birth in a possession, but who otherwise established a domicile in one of the Contracting States at the time of death or the making of a gift; nor would it apply to an individual who acquired his U.S. citizenship through birth in a possession, but who was domiciled at death, or the making of a gift, in a third state.

Paragraph 5 provides that the domicile of a person other than an individual shall be determined under the law of the appropriate Contracting State and, if necessary, by mutual agreement of the competent authorities.

Article 5. IMMOVABLE PROPERTY

Paragraph 1 provides that immovable property which forms part of the estate of or of a gift made by a person domiciled in a Contracting State and which is situated in the other Contracting State, may be taxed by that other State. This is a primary, but not exclusive, taxing right. Nothing in the Convention, for example, precludes the United States from taxing the transfer of German situs immovable property by an individual domiciled, for purposes of the Convention, in the United States, provided the United States allows a credit for the German tax.

According to paragraph 2, the term "immovable property" is defined in accordance with the law of the Contracting State in which the property is situated. The term generally includes property accessory to real property, livestock equipment used in agruculture and forestry, and rights to payment for the working of mineral deposits and other natural resources. Ships, boats, and aircraft are not considered immovable property. Although the Convention does not explicitly say so, debts secured by mortgage or similar preferential right are not to be treated as immovable property. Such debts are to be treated as movable property and covered by the general rule of Article 9 (Property Not Expressly Mentioned), unless Article 6 (Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for the Performance of Independent Personal Services), 7 (Ships and Aircraft), or 8 (Interests in Partnerships) applies.

According to paragraph 3, the rules of paragraph 1 and 2 apply to immovable property of an enterprise and to immovable property used for the performance of independent personal services. That is, immovable property may be taxed by the State where it is located, even if different from where the enterprise is located or where the independent personal services are performed.

Article 6. BUSINESS PROPERTY OF A PERMANENT ESTABLISHMENT AND ASSETS PERTAINING TO A FIXED BASE USED FOR THE PERFORMANCE OF INDEPENDENT PERSONAL SERVICES

Paragraph 1 establishes the primary taxing right for assets forming part of the business property of a permanent establishment. It provides that, except for assets referred to in Articles 5 (Immovable Property) and 7 (Ships and Aircraft), assets of an enterprise which form part of the estate or a gift made by a person domiciled in a Contracting State, which assets form part of the business property of a permanent establishment situated in the other Contracting State, may be taxed in that other State. Securities, provided they form part of the business property employed in a permanent establishment, are covered by this Article. Similarly, patents and trademarks owned by an individual, but constituting business property of a permanent establishment, are taxable under this Article. This paragraph does not apply to ships and aircraft and of movable property, including containers, pertaining to the operation of ships and aircraft. Such property is taxed under Article 7 (Ships and Aircraft).

As with real property, the permanent establishment rule is not an exclusive taxing right for the situs State. The United States may tax the German-situs business property of decedents or donors who are U.S. citizens on a residual basis, by virtue of the saving clause of subparagraph 1a) of Article 11 (Credits).

Subparagraph 2a) defines the term "permanent establishment" as a fixed place of business through which the business of an enterprise is wholly or partly carried on. Illustrations of a permanent establishment are provided in subparagraph 2b). They include a place of management, a branch, an office, a store or other sales outlet, a factory, a workshop, and a mine, quarry, or any other place of extraction of natural resources.

Subparagraph 2b) also states that a building site or construction or assembly project constitutes a permanent establishment only if it lasts for more than 12 months. This 12-month period begins when work physically commences in the Contracting State, must be fulfilled on a consecutive-month basis, and ends with the date of death or making of a gift. A series of contracts or projects which are interdependent commercially is to be treated as a single project for the purpose of applying the 12-month test. The 12-month test will not be fulfilled if the assets in question are transferred by death or the making of a gift before the 12 months has elapsed, even if it appeared, at the time of death or the making of the gift, that the project would have lasted more than 12 months.

Subparagraph 2c) lists examples of activities that will not constitute a permanent establishment, even if conducted through a fixed place of business. The paragraph provides that a permanent establishment does not include: the use of facilities for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise; the maintenance of a stock of goods or merchandise belonging to the enterprise for the purpose of storage, display, or delivery; the maintenance of a stock of goods or merchandise belonging to the enterprise for the purpose of processing by another enterprise; the maintenance of a fixed place of business for the purpose of purchasing goods or merchandise, or collecting information, for the enterprise; or the maintenance of a fixed place of business for the purpose of advertising, for the supply of information, for scientific research, or for similar activities, if they have a preparatory or auxiliary character, for the enterprise.

Under subparagraph 2d), an enterprise, of a Contracting State, even if it does not have a permanent establishment in the other Contracting State under subparagraphs 2a) to 2c) of this paragraph, shall be deemed to have a permanent establishment in the latter State if it is engaged in trade or business in that State through an agent who has an authority to conclude contracts in the name of the enterprise and regularly excercises that authority in that State, unless the exercise of authority is limited to the purchase of goods or merchandise for the account of the enterprise.

Subparagraph 2e) provides, however, that an enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other State merely because such enterprise is engaged in a trade or business in the other Contracting State through a broker, general commission agent, or any other agent of an independent status, where the broker or agent is acting in the ordinary course of his business.

Under subparagraph 2f), the fact that a resident or corporation of a Contracting State controls, is controlled by, or is under common control with a corporation of the other Contracting State or with a corporation engaged in trade or business in that other State, whether through a permanent establishment or otherwise, shall not be a factor in determining whether that resident or corporation has a permanent establishment in that other State.

Paragraph 3 provides that, except for assets referred to in Article 5 (Immovable Property), assets forming part of the estate or gift made by a person domiciled in a Contracting State and pertaining to a fixed base situated in the other Contracting State and used for the performance of independent personal services may be taxed in that other State. The concept of a "fixed base" is analogous to that of a "permanent establishment."

Article [illegible]. SHIPS AND AIRCRAFT

This Article establishes the taxing right for ships and aircraft. It provides that ships and aircraft operated in international traffic and belonging to an enterprise which forms part of the estate of or of a gift made by a person domiciled in a Contracting State, and movable property pertaining to the operation of such ships and aircraft, may be taxed only in that State.

This Article gives the Contracting State of domicile the exclusive right to tax and ships and aircraft operated in international traffic and related movable property. It thus differs from Articles 5 (Immovable Property) and 6 (Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for the Performance of Independent Personal Services) which provide for primary, but not exclusive, situs-basis taxation.

Article 8. INTERESTS IN PARTNERSHIPS

This Article establishes the taxing right to certain partnership interests. It provides that an interest in a partnership which forms part of the estate of or of a gift made by a person domiciled in a Contracting State which partnership owns property described in Article 5 (Immovable Property) or 6 (Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for the Performance of Independent Personal Services), may be taxed by the Contracting State in which the property is situated. The situs State may tax the partnership interest only to the extent that the value of the interest is attributed to the described property. Suppose the estate of a decedent domiciled in the United States contained an interest in a partnership owning immovable property in both the United States and the Federal Republic of Germany. In that case, the Federal Republic of Germany would be able to tax only that part of the interest which corresponds to the value of the immovable property situated in Germany. This Article reflects the view that the existence of a partnership should not prevent the situs State from imposing its tax. It allows the situs State to impose a tax even though a partnership interest, not the property which the interest represents, forms part of the estate or gift. In effect, the situs State is allowed to "look through" the partnership and tax the underlying property.

Article 9. PROPERTY NOT EXPRESSLY MENTIONED

This Article contains the taxing rule for property not covered by Article 5 (Immovable Property), 6 (Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for the Performance of Independent Personal Services, 7 (Ships and Aircraft) or 8 (Interests in Partnerships). It provides that property which forms part of the estate of or of a gift made by a person domiciled in a Contracting State and which is not dealt with in those Articles shall, subject to paragraph 1 of Article 11 (Credits), be taxable only in the Contracting State in which the person is domiciled. Under this Article, for example, the Federal Republic of Germany has the primary right to tax shares of stock in a U.S. corporation which form part of the estate of a decedent domiciled in the Federal Republic of Germany. If the decedent is also a U.S. citizen, the United States also would be able to tax those shares under subparagraph 1a) of Article 11 (Credits), provided the United States allows a credit for the German tax imposed on the shares.

Article 10. DEDUCTIONS AND EXEMPTIONS

Paragraph 1 provides rules for property taxable only in accordance with Article 5 (Immovable Property), 6 (Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for the Performance of Independent Personal Services), or 8 (Interests in Partnerships). As explained above, these articles apply to property forming part of the estate or a gift of a person domiciled in a Contracting State, but which is located in the other Contracting State. Thus, the paragraph 1 rules are relevant only for property taxable on a situs basis and specify the deductions which the situs State must allow.

Subparagraph 1a) applies to property referred to in Article 5 (Immovable Property) and provides that debts incurred for the acquisition, repair, or upkeep of that property shall be deductible from the value of such property. Subparagraph 1b) applies to property covered by Article 6 (Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for the Performance of Independent Personal Services) and requires that debts incurred in connection with the operation of the permanent establishement or the fixed based shall be deductible from the value of property covered by that Article. Finally, subparagraph 1c) covers property referred to in Article 8 (Interests in Partnerships) and provides for the deductibility of debts to which subparagraphs 1a) and 1b) of this Article would apply, if the property were owned directly rather than through a partnership.

Paragraph 1, which allows debts to be deducted from the value of property against which they are secured or connected, differs from U.S. statutory law. With respect to the taxation of nonresident aliens, the Code provides for the apportionment of expenses, claims, and other indebtedness based on the location of relative values of the estate. Paragraph 1 allows either, but not both, of these methods of deduction.

Consider the case of a German domiciliary who dies holding real estate in the United States with a market value of $500,000, but subject to a mortgage of $200,000. The estate also incurs administrative expenses of $100,000. The estate has non-U.S. situs property with a gross value of $500,000, for a total gross estate of $1,000,000. Under U.S. statutory law, the estate would be entitled to deduct a proportionate amount of the allowable indebtedness and expenses of $300,000. Since one-half the estate is located and taxable in the United States, a deduction of $150,000 would be allowed. Under the Convention, the estate could deduct the full $200,000 mortgage allowed by the treaty. If, however, the estate chose the $200,000 deduction allowed by the Convention, it would not be entitled to also deduct a proportionate amount of the remaining $100,000 in administrative expenses. Another way of stating this is that the term "debts" in Article 10 encompasses all the expenses and indebtedness that would be deductible, and therefore apportionable, under U.S. statutory law. The United States will not grant a special non-statutory deduction plus the statutory deduction.

Paragraph 2 provides that property transferred to or for the use of a corporation or organization of a Contracting State organized and operated exclusively for religious, charitable, scientific, educational, or public purposes shall be exempt from tax by the other Contracting State, provided the transfer is exempt from tax in the first-mentioned Contracting State, and would be tax exempt if made to a similar entity in that other State. Sections 2055(a)(2) and 2522(a)(2) of the Code provide U.S. citizens or residents with a deduction for estate and gift tax purposes for transfers of property to or for the use of a domestic or foreign corporation organized for religious, charitable, scientific, or educational purposes. Sections 2055(a)(1) and 2522(a)(1) allow a deduction for transfers of property to the United States or any political subdivision for exclusively public purposes. In the case of nonresident aliens, however, sections 2106(a)(2) and 2522(b)(2) allow a deduction for estate and gift tax purposes only for the transfer of property to, or for the use of, domestic corporations organized and operated for these purposes. A deduction is not allowed for the transfer of property by a nonresident alien to a foreign corporation organized for religious, charitable, scientific, or educational purposes. Paragraph 2 of the Convention would allow such a deduction. Similarly, sections 2106(a)(1) and 2522(b)(1) do not allow a deduction for property transferred to a foreign political entity, but paragraph 2 would allow such a deduction.

Under this provision the United States would allow a deduction for the transfer of property by a domiciliary of the Federal Republic of Germany to a corporation or organization of the Federal Republic of Germany organized and operated exclusively for religious, charitable, scientific, educational, or public purposes, or to a public body of the Federal Republic of Germany to be used for such purposes, provided the transfer is tax exempt in the Federal Republic of Germany and that it would be deductible if made to a similar U.S. corporation or organization. The competent authorities of the Contracting State are to settle the application of this provision by mutual agreement. Since this paragraph, according to paragraph 1 of Article 11 (Credits), is an exception to the saving clause, it requires the Federal Republic of Germany to allow a deduction for a contribution by either a German or a U.S. domiciliary to a U.S. corporation, organization, or public body operated for the specified purposes, provided the contribution would be tax exempt if made to a similar corporation, organization, or public body of the Federal Republic of Germany.

Paragraph 3 provides for the exemption from tax of certain pensions, annuities, and other amounts. It applies in the case of a pension, annuity, or other amount paid to a domiciliary of a Contracting State: (1) by the other Contracting State or political subdivision thereof, or (2) out of a public fund organized under the public laws of that other Contracting State, or (3) under a plan maintained by a person resident in that other Contracting State, under the Social Security laws of that State, as consideration for services rendered, or as compensation for injury or damage sustained. The paragraph provides that such amounts will be exempt from tax in the State in which the recipient is domiciled, but only if the amount paid would be exempt if the recipient were domiciled in the other Contracting State. The amounts exempted may be offset against the "Versorgungsfreibetrag," an exemption available to the surviving spouse of a German domiciliary. Thus, the amounts exempted by the Federal Republic of Germany under paragraph 3 may reduce the value of that interspousal exemption.

Paragraph 4 obligates a Contracting State to give a marital deduction for interspousal transfers of certain types of noncommunity property from domiciliaries or citizens of the other Contracting State. Paragraph 4 applies to property covered by Article 5 (Immovable Property), 6 (Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for the Performance of Independent Personal Services), or 8 (Interests in Partnerships) and provides that interspousal transfers of such property may be included in the taxable base of the Contracting State in which the property is located only to the extent the value exceeds 50 percent of all the property which may be taxed by that State. Thus, noncommunity property taxable in the Federal Republic of Germany under these Articles and transferred from a U.S. domiciliary to his or her spouse may be taxed by the Federal Republic of Germany only to the extent it exceeds 50 percent of all property which may be taxed by the Federal Republic of Germany.

Subparagraphs 4a) and 4b) limit the marital deduction obligation of the Federal Republic of Germany and the United States, respectively. Subparagraph 4a) provides that the exclusion from the taxable base in the Federal Republic of Germany shall not exceed the general marital deduction available to transfers between spouses subject to unlimited German inheritance and gift tax liability.

Subparagraph 4b) limits the marital deduction obligation of the United States to the tax that would be due by applying the rates applicable to a U.S. domiciliary to the base determined under paragraph 4. Under the Internal Revenue Code, nonresident aliens are not allowed a marital deduction, but are entitled to significantly lower rates on transfers of estates. Subparagraph 4b) provides that the tax imposed by the United States on interspousal transfers of noncommunity property by a domiciliary of the Federal Germany who receives the marital deduction under paragraph 4 shall be computed by applying the tax rates applicable to a domiciliary of the United States. The resulting liability would be compared with that imposed on a nonresident alien under U.S. statutory law (taking the other rules of the Convention into account), and the tax liability would be limited to the lower of the two amounts.

Assume, for example, that a Germany domiciliary dies with a taxable estate, after taxing into account any applicable deductions, of $2,000,000 in noncommunity property. The entire estate is comprised of property that may, under the Convention, be taxed by the United States. All the property is transferred to the decedent's spouse. According to the Convention, the taxable base is the excess of 50 percent of all taxable property, or $1,000,000. The tax rates applicable to a U.S. domiciliary are applied to this tax base. If the decedent had been domiciled in the United States, the tax liability, under present law, on $1,000,000 would be $248,300 plus 39 percent of the excess over $750,000 or $345,800. This is the maximum U.S. tax liability in this case and compares favorably with the $144,000 plus 24 percent of the excess over $1,000,000 or $384,000 tax liability on the estate of the Germany domiciliary under U.S. law, apart from the Convention. Under either calculation, the individual is entitled to the unified credit available to nonresident aliens under U.S. statutory law. In no event is the individual entitled to any portion of the unified credit available under U.S. statutory law to domiciliaries.

If, on the other hand, only $500,000 was transferred to the decedent's spouse, the taxable base, under the Convention, would be the $1,500,000 in property not transferred to the spouse. Applying the tax rates to a U.S. domiciliary to this base would result in a tax liability of $448,300 plus 43 percent of the excess over $1,250,000 or $555,800. In this case, the Convention provision does not provide for reduced taxation.

Article 11. CREDITS

Paragraph 1, with certain exceptions, allows the United States to tax its citizens and the Federal Republic of Germany to tax its domiciliaries as if the Convention did not exist. This "saving" clause preserves the right of the United States to tax its citizens and the Federal Republic of Germany to tax its domiciliciaries under domestic law.

According to subparagraph 1a), the Convention does not preclude the United States from taxing under its domestic law the estate or gift of a U.S. citizen. The United States includes this provision in its tax conventions because it imposes tax on a worldwide basis on its citizens, wherever they are domiciled, and because it generally views a tax convention as affecting its right to tax domiciliaries of the other State, but not its right to tax its own citizens.

The term "citizen" includes, for a 10-year period, a former citizen who renounced his citizenship primarily for tax avoidance purposes. This provision of the saving clause parallels sections 2107 and 2501(a)(3) of the Internal Revenue Code, which provide that certain transfers of this class of expatriates will be subject to citizen or resident estate and gift tax rates.

Subparagraph 1b) does not preclude the Federal Republic of Germany from taxing in accordance with its law an heir, donee, or other beneficiary domicilied in the Federal Republic of Germany at the time of death of the decedent or the making of a gift.

Pursuant to the restrictions in paragraph 1, the saving clause does not relieve a Contracting State from certain obligations under the Convention. Paragraph 1, for example, ensures that the saving clause will not override the obligation of a Contracting State, in accordance with Article 11 (Credits), to credit taxes paid to the other Contracting State on either a domiciliary or a situs basis.

Paragraph 1 also provides that the saving clause shall not affect the benefits conferred by a Contracting State under paragraph 2 of Article 10 (Deductions and Exemptions), relating to deductions for contributions to charitable organizations, paragraph 3 of Article 10, relating to the exemption of pensions, paragraph 4 of Article 10, relating to interspousal transfers, or Article 13 (Mutual Agreement Procedure).

The remaining paragraphs of this Article describe the mechanics for avoidance of double taxation. They establish rules for determining when a Contracting State will credit the taxes of the other Contracting State where both States tax the same property. This can happen, for example, because the situs State has the primary, but not exclusive, right to tax property covered by Article 5 (Immovable Property), 6 (Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for the Performance of Independent Personal Services), or 8 (Interests in Partnerships), but under the Convention the State of domicile may also tax this property.

Paragraph 2 applies when the United States imposes tax on the basis of an individual's domicile (as determined under Article 4 (Fiscal Domicile)) or citizenship. Under paragraph 2a), the United States will credit tax paid to the Federal Republic of Germany with respect to property described in Article 5 (Immovable Property), 6 (Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for the Performance of Independent Personal Services), or 8 (Interests in Partnerships). In addition, the United States is required under subparagraph 2b), when it taxes on the basis of citizenship, to credit taxes imposed by the Federal Republic of Germany on the basis of the individual's domicile. This provision obligates the United States, for example, to credit the tax imposed by the Federal Republic of Germany, on shares of stock in a U.S. corporation transferred by a U.S. citizen domiciled in the Federal Republic of Germany.

Paragraph 3 establishes reciprocal credit rules for the Federal Republic of Germany. Where the Federal Republic of Germany imposes tax on the basis of the domicile of the decedent, donor, heir, donee, or other beneficiary, subparagraph 3a) requires the Federal Republic of Germany to credit any U.S. tax imposed in accordance with Article 5 (Immovable Property), 6 (Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for the Performance of Independent Personal Services), or 8 (Interests in Partnerships). Where the decedent or donor was domiciled in the United States and where the Federal Republic of Germany imposes tax on the basis of the domicile of the heir, donee, or other beneficiary, subparagraph 3b) requires the Federal Republic of Germany to credit U.S. tax imposed on the basis of domicile.

Consider the case of a U.S. domiciliary who dies and transfers stock in a German corporation to an individual domiciled in the Federal Republic of Germany. Under Article 9 (Property Not Expressly Mentioned) of the Convention, the United States has the primary right to tax the shares in the German Corporation. The Federal Republic of Germany may tax the shares under subparagraph 1b) of this Article, but is obligated under subparagraph 3b) of this Article to credit the U.S. tax imposed on the shares. In other words, the Federal Republic of Germany may only tax the shares on a residual basis.

Section 2011(a) of the Internal Revenue Code allows a credit against the Federal estate tax for estate and inheritaance taxes paid to any state or the District of Columbia. Section 2011(b) specifies limits on this credit. Paragraph 4 of the Convention requires the Federal Republic of Germany to credit taxes levied by political subdivisions of the United States, provided the sub-Federal taxes otherwise qualify as creditable taxes under the provisions of paragraph 3. If the sub-Federal taxes are not creditable under paragraph 3, paragraph 4 provides that the competent authorities may consult under the provisions of Article 13 (Mutual Agreement Procedure) for the purpose of avoiding double taxation.

Paragraph 5 is intended to preserve the relief from double taxation provided by paragraphs 2, 3, and 4 when double taxation results from difference in the timing of taxable events or from taxes imposed on successive transfers. Subparagraph 5a) requires each Contracting State to take into account in an appropriate way a gift tax imposed by a Contracting State on property subsequently included in an estate that is taxed by the other Contracting State. Typically, subparagraph 5a) would provide for the credit of a gift tax against a subsequently-levied estate tax. Consider the case of a Federal Republic of Germany domiciliary making a gift of U.S. real property which is subject to U.S., but not Federal Republic of Germany gift tax. If the Federal Republic of Germany eventually taxes that property at the time of the donor's death, subparagraph 5a) would require it to credit the previously-levied U.S. gift tax.

Subparagraph 5b) requires each Contracting State to take into account in an appropriate way any credit allowed by a Contracting State for estate or gift taxes imposed on prior taxable events. It is aimed at preserving the credit allowed by paragraphs 2,3, and 4 of this Article if a Contracting State provides internal relief on successive transfers of property. Normally, it would require that the credit allowed by a Contracting State under paragraph 2, 3, or 4 shall not be reduced by any credit allowed by the other Contracting State for taxes paid on prior transfers. For example, section 2013 of the Code is intended to prevent diminution of an estate by successive taxes on the same property within a brief period. It provides U.S. citizens or residents with an estate tax credit for Federal estate taxes paid on the transfer of property to the present decedent from an individual who died within 10 years before or 2 years after the present decedent. The amount of the credit varies inversely with the length of time between the successive deaths. It is not necessary that the transferred property be identified in the present decedent's estate, or even that the property be in existence at the date of his death. Subparagraph 5b) would require the Federal Republic of Germany to acknowledge section 2013-type relief by crediting the full tax allowed by paragraphs 2, 3, or 4, unreduced by any credit allowed by the United States for taxes paid on previous taxable events. Paragraph 5 states a general principle, rather than any specific rule. Thus, it provides that any difficulties arising as to the application of the provisions of paragraph 5 are to be resolved by the competent authorities under Article 13 (Mutual Agreement Procedure).

Paragraph 6 limits the credits allowed by this Article to the tax imposed by a Contracting State on the property in respect of which a credit is claimed. The purpose of the limitation is to prevent a credit from eroding the tax imposed by a Contracting State on estates or gifts which may not, under the Convention, be taxed by the other State. In making this calculation the tax on the property is determined before the credit is given.

Consider the case of a decedent who was a U.S. citizen domiciled in the Federal Republic of Germany whose estate consisted of U.S. real property with a fair market value of $20 and assets in the Federal Republic of Germany with a fair market value of $100. The decedent makes no transfers which would qualify for either charitable or marital deduction relief under U.S. or German law. The entire $120 gross estate is taxable in the United States on the basis of citizenship and in the Federal Republic of Germany on the basis of domicile. The United States retains primary taxing jurisdiction over the U.S. real property and the Federal Republic of Germany over the other assets. If the inheritance tax in the Federal Republic of Germany on the $120 estate were $24 and the U.S. estate tax were $30 before the allowance for any credits under this Article, the Federal Republic of Germany would credit $4 of U.S. tax ($20/$120) x ($24). Although $5 represents the portion of the U.S. tax of $30 attributable to U.S. real property ($20/$120) x ($30), the credit would be limited to $4, which is the portion of the $24 tax in the Federal Republic of Germany attributable to the U.S. real property. The United States would credit the $20 of net tax paid to the Federal Republic of Germany which represents the portion of the $24 in tax that is attributable to property not located in the United States ($100/$120) x ($24). The net tax liability in the Federal Republic of Germany would be $20 ($24 less $4) and the net U.S. tax liability would be $10 ($30-20).

Paragraph 7 specifies a time period for claiming the credit under this Article. Under section 2014(e) of the Code, the credit for foreign death taxes must be claimed by the later of: 4 years from the filing of the estate tax return; the expiration of any extension of time for paying the Federal estate tax; or 60 days after a final decision of the Tax Court on a timely filed petition for redetermination of a deficiency. Paragraph 7 extends the time period by providing that any claim for credit or refund based on this Article may be made until one year after the final determination and payment of tax for which credit is claimed, provided the determination and payment are made within 10 years of the date of death or gift. The competent authorities may extend the ten-year time limit if circumstances prevent the determination of tax within such period. Any refund based solely on the provisions of the Convention will be made without payment of interest.

Article 12. TRUSTS AND ESTATES

This Article is addressed to the problem which may arise due to differences in the timing of taxable events when property is placed in trust. U.S. tax liability usually arises, for example, when a trust is created. But under the German inheritance tax, tax liability generally does not arise until the heir actually receives something from the trust. Under its domestic law, the Federal Republic of Germany will not allow a credit for foreign tax paid more than 5 years before tax liability arises in the Federal Republic of Germany. Thus, under the domestic laws of the two Contracting States, it is possible that the Federal Republic of Germany would provide no credit for a previously-levied U.S. tax. Article 12 is intended to facilitate a credit in this and similar instances.

Paragraph 1 provides that the provisions of the Convention shall not prevent a Contracting State from applying its rules regarding the recognition of a taxable event with respect to property transferred to and from a trust. Under paragraph 2, where taxable events occur at different times, the competent authorities may discuss the case under Article 13 (Mutual Agreement Procedure) with a view to avoiding hardship, provided the difference in the timing of taxable events does not exceed 5 years. Paragraph 3 provides a method of relief where the difference in the timing of taxable events is likely to exceed 5 years. In a case where the transfer of property to an estate or trust does not result in tax liability under the German inheritance and gift tax, paragraph 3 allows the beneficiary of the estate or trust to elect to be subject to all German taxation, including income taxation. This election would allow the beneficiary to be eligible for the competent authority relief provided in paragraph 2 of this Article.

Article 13. MUTUAL AGREEMENT PROCEDURE

This Article specifies a procedure for resolving differences arising out of the administration and application of the Convention. Under paragraph 1, if a person considers that the actions of one or both of the Contracting States result or will result in taxation which is not in accordance with the Convention, he may present his case to the competent authority of either Contracting State. Although a person need not exhaust other administrative or judicial remedies prior to resorting to the mutual agreement procedure, it is expected that a person normally will do so. Nor is it required that the actions concerned already have resulted in taxation not in accordance with the Convention. The threat of such taxation is sufficient to justify a presentation to the competent authority. Such a presentation must be made, however, within one year after a claim under the Convention for exemption, credit, or refund has been finally settled or rejected.

Paragraph 2 provides that if the competent authority to which a case is presented considers an objection justified and cannot by itself arrive at a satisfactory solution, it will attempt to resolve the case by discussion and agreement with the competent authority of the other Contracting State.

Paragraph 3 permits the competent authorities of the Contracting States to endeavor to resolve difficulties or doubts regarding the interpretation or application of the Convention, such as the meaning of terms. The competent authorities may also consult for the purpose of eliminating instances of double taxation which are not covered by the Convention.

Under paragraph 4, the competent authorities may communicate with each other directly and, when advisable, meet together for an oral exchange of opinions, for the purpose of reaching an agreement.

In cases where the competent authorities reach an agreement, paragraph 5 provides that taxes will be imposed and, notwithstanding any procedural rule applicable under the laws of the Contracting States, refund or credit of taxes will be allowed in accordance with the Convention. This provision can only help a taxpayer. In the case of the United States, where an agreement is reached between the competent authorities which requires the United States to make a refund or allow a credit of tax, the refund or credit will be made, assuming presentation of the case to the competent authority within a reasonable time, notwithstanding any procedural barriers existing under U.S. law, including any statute of limitations. On the other hand, no additional tax will be imposed if foreclosed by a statute of limitations or a closing agreement. In cases where an agreement cannot be reached between the competent authorities, the United States is not required to provide relief from double taxation on a unilateral basis.

Article 14. EXCHANGE OF INFORMATION

This article provides for a system of administrative cooperation between the Contracting States. Paragraph 1 requires the exchange of information necessary for carrying out the provisions of the Convention or the domestic laws of the Contracting States concerning the taxes covered by the Convention. Such exchange may be either upon request or on a routine basis not requiring a specific request. The requirement to exchange information is not restricted by Article 1 (Scope); thus, information may be exchanged on estates and gifts by individuals not domiciled in either Contracting State. The competent authorities may exchange information in connection with tax compliance generally, as well as information regarding illegal acts or crimes. Any information received by a Contracting State must be treated as secret, in the same manner as information obtained under the domestic laws of that State. The information may be disclosed only to persons or authorities (including a court or administrative body) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes which are the subject of the Convention. Persons receiving information shall use the information only for the specified purposes, but they may disclose such information in public court proceedings or judicial decisions.

Paragraph 2 places limits on the obligations imposed on a Contracting State by paragraph 1. A Contracting State is not required: to carry out administrative measures at variance with the laws and administrative practice of either Contracting State or to supply information unobtainable under the laws or normal administrative practice or either Contracting State. Thus, a Contracting State is not bound to go beyond its own laws and practice in making information available to the other State. In addition, it need not supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

Paragraph 3 prescribes the method for collecting requested information and the form in which such information is to be provided. A Contracting State shall obtain the information requested by the other Contracting State (including depositions of witnesses and copies of relevant documents) in the same manner it would employ for obtaining information with respect to its own tax.

Paragraph 4 is an anti-tax avoidance provision. It provides that where property would be taxable only in the Contracting State in which the decedent or donor was domiciled according to Article 7 (Ships and Aircraft) or 9 (Property Not Expressly Mentioned), without regard to paragraph 1 of Article 11 (Credits), and where the tax due in that State is not paid, then the competent authorities may agree that the tax may be imposed with respect to such property in the other Contracting State, notwithstanding Article 7 (Ships and Aircraft) or 9 (Property Not Expressly Mentioned). Provided the competent authorities agree, this paragraph would allow the United State to tax property covered by Article 7 (Ships and Aircraft) or 9 (Property Not

Expressly Mentioned) in the estate of a decedent domiciled, under the Convention, in the Federal Republic of Germany, provided the decedent was also a U.S. citizen or was domiciled in the United States under U.S. domestic law.

Article 15. DIPLOMATIC AGENTS AND CONSULAR OFFICERS

Diplomatic agents and consular officers frequently are accorded benefits under international laws and agreements. Paragraph 1 preserves these benefits.

Paragraph 2 makes clear that the Convention does not apply to officials of international organizations and members of a diplomatic or consular mission of a third State, established in a Contracting State but not domiciled in either Contracting State. These individuals usually are covered by a Convention concluded by the State or international organization which they represent. Consequently, this paragraph is intended as a safeguard against undesirable fiscal advantages: to make it clear that these individuals are not entitled to benefits both of a Convention arising from their employment status and from a Convention of the Contracting State in which they are established. The paragraph states explicitly what can be inferred from paragraph 1 of Article 1 (Scope); the Convention does not generally apply to individuals not domiciled in either Contracting State.

Article 16. LAND BERLIN

This Article provides that the Convention applies to Land Berlin, provided the Federal Republic of Germany does not make a contrary declaration to the United State of America within three months of the Conventions date of entry into force.

Article 17. ENTRY INTO FORCE

This Article specifies the procedure for bringing the Convention into force. Paragraph 1 provides that the Convention shall be ratified in accordance with the applicable procedures of each Contracting State and that instruments of ratification are to be exchanged at Washington as soon as possible after both States have ratified the Convention.

Paragraph 2 provides that the Convention will enter into force immediately upon the exchange of instruments of ratification and will apply to estates of persons dying and gifts made on or after January 1, 1979.

Paragraph 3 is a transitional rule aimed at providing relief from double taxation in the case of estates of persons having died on or after January 1, 1974 and before January 1, 1979. It provides that in such a case, the competent authorities may consult with a view to eliminating double taxation not avoided by measures available under the internal laws of each Contracting State. The competent authorities may, under Article 13 (Mutual Agreement Procedure), agree that the taxes of one Contracting State may be credited against the taxes of the other Contracting State, notwithstanding differences of internal rules regarding situs and domicile.

Article 18. TERMINATION

This Article specifies the procedure for terminating the Convention, which is to remain in force indefinitely until terminated by one of the Contracting States. A Contracting State may not terminate the Convention until it has been in force at least 3 years. After the initial 3-year period, either Contracting State may terminate the Convention by providing the other State at least 6 months prior notice through diplomatic channels. The notice must specify the date of termination. If the Convention is terminated in accordance with these procedures, it will have no effect with respect to estates of persons dying and gifts made after the December 31 following expiration of the six-month period.

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APPENDIX II: ADDITIONAL LETTERS

SEPTEMBER 15, 1981.

Hon. ROBERT DOLE,
Vice Chairman, Joint Committee on Taxation, U.S. Senate, Washington, D.C.

DEAR BOB: In your capacity as Chairman of the Senate Finance Committee and Vice-Chairman of the Joint Committee on Taxation, we would like to invite you to appear during the September 24 hearings of the Foreign Relations Committee on a series of tax treaties. Senator Percy will be chairing the hearing on the Tax Treaty with Canada beginning at 10:00 a.m. and Senator Mathias will be chairing a hearing on ten other tax treaties beginning at 2:00 p.m. the same day.

In view of the impact of these treaties on our tax system, we would like to be sure that they have the general support of you and the membership of the tax-writing committees. We would be glad to accommodate an appearance by you or another member of the Senate from your Committee either in the morning or the afternoon hearing. We are also extending a similar invitation to Congressman Dan Rostenkowski.

We will be hearing testimony from members of the staff of the Joint Committee on Taxation, who have already provided our Committee with an excellent series of analyses of the treaties presently before us for consideration. We appreciate their excellent contributions in this regard.

Sincerely,

CHARLES H. PERCY,
Chairman.

CHARLES McC. MATHIAS, JR.,
Chairman, Subcommittee on International Economic Policy.

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C., October 8, 1981.

Hon. CHARLES H. PERCY,
Chairman, Committee on Foreign Relations, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: Thank you for your gracious invitation to present my views to the Foreign Relations Committee on the tax treaties currently pending before it. I understand that Senator Long, the ranking minority member of the Finance Committee, may also respond to your invitation. Your invitation, and the similar invitation you extended to the Chairman and ranking minority member of the Ways and Means Committee, may serve as the catalyst for needed improvement in the process by which the Senate renders its advice and consent to tax treaties.

THE TREATY PROCESS

In implementing their objectives, tax treaties inevitably modify the tax rules and policies established by the Congress and embodied in the Internal Revenue Code. Indeed, the Code itself recognizes this in providing in sections 894 and 7852(d) that treaty provisions may override statutory provisions.

However, the displacement of the policies established in the Code by the sometimes conflicting policies established through the tax treaty process gives me, as a member who devotes considerable time and energy to the tax legislative process, cause for some concern. Particularly as the United States tax treaty network grows and as tax treaties become more detailed and complex, this concern regarding the possible conflicts between the tax legislative process and the tax treaty process can only increase.

Your solicitation of the involvement of the tax-legislation-writing committees in the tax treaty process is a helpful first step in allaying those concerns. Precisely because a number of the pending treaties present possible conflicts with tax issues either presently of concern to the members of the Finance Committee or recently the subject of carefully considered tax legislation, your invitation in this instance is most welcome. Because all 20 members of the Finance Committee have an interest in minimizing the conflicts between the tax legislative process and the tax treaty process, however, and because this submission cannot purport to reflect all the members' views, I have suggested to the other members that they may wish to communicate their views to you separately.

Equally important, further initiatives to improve the coordination of the tax legislative process with the tax treaty process will come, I hope, from the Department of Treasury. Such initiatives should include, at a minimum, consultation with the chairmen of the Foreign Relations Committee and the Finance and Ways and Means Committees at several stages of the treaty negotiation process.

First, before negotiations are commenced, I suggest that the Treasury notify Congress regarding the reasons for seeking a new tax treaty. In the case of a protocol to an existing treaty or a treaty to replace an existing treaty, such notification ought to include an explanation of the specific provisions of the extant treaty and U.S. or foreign law, and an explanation of any changed economic conditions, which together may give rise to the need for a revised treaty. Further, the Treasury might provide Congress a description of the goals hoped to be achieved through the adoption of a new treaty or protocol. For treaties with nations with whom we have no existing tax treaty such notification should include a description of the problems U.S. taxpayers may experience in commercial and other contacts with the other nation's taxing jurisdiction, the commercial activity that might be fostered by such a treaty, and what interests of the U.S. might be served by promoting trade with or investment between the U.S and the other nation. In the present group of treaties, some early explanation of the goals to be achieved through tax treaties with developing countries with whom U.S. taxpayers have minimal commercial contacts would have cleared up a number of questions.

Second, once negotiations have commenced, periodic consultation with Congress regarding progress, problems, and the choices among options in the treaty negotiation process could facilitate the process of later Senate ratification. I understand that such consultation is often sought in the case of treaties outside of the tax area. While we all wish not to "politicize" every issue under negotiation some level of contact would be disirable. The need for Senate recommendations, clarifications, or even possible reservations regarding some of the pending treaties could have been obviated by even the most cursory level of communication between Congress and the Treasury during the negotiation stage.

Third, the Treasury should find it useful during the tax legislative process itself, to keep the tax-writing committees abreast of the impact of pending legislation on ongoing treaty negotiations. Recent legislative decisions in the real property and foreign convention areas, for instance, might have been better informed had the decision-makers been fully aware of the status and substance of ongoing treaty negotiations, particularly those with Canada. Coordination between treaty negotiators and those involved in the tax legistlative process could avoid the development of conflicting provisions.

REVENUE EFFECT

For the Senate to give its informed advice and consent to these treaties, particularly in these days when budget questions loom large on every front, it will be necessary to obtain a more-than-speculative indication of the revenue impact of these treaties. Especially where a treaty or protocol deems a foreign tax creditable against U.S. tax which, under the Code, would not be creditable, some more-than-negligible loss to the Treasury may be involved. I recommend, therefore, that the Foreign Relations Committee withhold further action on any of the treaties until detailed revenue estimates are supplied regarding each of the pending treaties.

FOREIGN INVESTMENT IN U.S. REAL PROPERTY

As part of the Omnibus Reconciliation Act of 1980, Congress enacted the Foreign Investment in U.S. Real Property Tax Act (FIRPTA), a statute designed to tax the disposition of direct or indirect investments in U.S. real property by nonresident aliens and foreign corporations. The members of the Finance Committee took a great deal of interest in developing this legislation in response to popular insistence that foreign investment in U.S. real property bear at least the same tax burdens as domestic investment. It was not without some difficulty that these concerns were balanced against desires not to discourage foreign investment in the United States for unwarranted reasons. Several of the pending treaties, however, seem to disrupt the balance struck by that legislation.

One such disruption is the application of the nondiscrimination article of several treaties. FIRPTA clearly indicated that the statute would override existing treaties, on this and any other conflicting points. It was expected that new treaties would specifically state whether or not FIRPTA overrode conflicting treaty provisions; many members expected that new treaties would specifically state that FIRPTA always overrode possibly conflicting treaty provisions. Several treaties do not make such a statement. I recommend, therefore, that approval of the treaties be subject to the explicit understanding that the treaty nondiscrimination provisions do not override FIRPTA. This is, we understand, consistent with Treasury's interpretation.

Several treaties cede substantial portions of the taxing jurisdiction asserted by FIRPTA. Both the Canadian and the Argentine treaties alter the statutory method for determining whether an entity is a U.S. real property holding organization by excluding trade or business property from real property. Second, a number of the treaties treat partnerships, trusts, and estates as entities rather than conduits for the purposes of determining whether and when a nonresident alien will be treated as making a taxable disposition of a U.S. real property interest.

Third, the Canadian treaty includes a provision which prevents either country from taxing gains on the sale of real property holding companies by residents of the other unless the other country would tax foreign investors on their real property holding companies in comparable circumstances. Fourth, the Canadian treaty uses a different standard than that provided by FIRPTA for determining whether a Canadian shareholder of a real property holding organization is taxed on the sale of his interest.

Each of these items appears to run contrary to our intent in enacting FIRPTA and, if accepted, would constitute significant concessions of U.S. taxing jurisdiction. Because the combined effect of these concessions may be to undermine the thrust and efficacy of FIRPTA, particularly in the case of the Canadian treaty, I recommend that a full explanation of the rationale for these concessions be provided before the committee approves these treaties.

It is understood that many of these items which today constitute significant concessions of U.S. taxing jurisdiction, may have been less significant if considered prior to FIRPTA's enactment. In light of FIRPTA, therefore, and in light of considerable sentiment that the taxes imposed by FIRPTA are not to be bargained away, the Treasury may wish to approach the Canadians to renegotiate these points.

The Canadian treaty also overrides FIRPTA in permitting a step-up in basis for Canadian-owned U.S. real property to the effective date of the new treaty. It is understood that this provision is designed to avoid a substantial number of sales and repurchases of property prior to the effective date of the new treaty. Generally, the gain on such sales would be protected from taxation under the present treaty. While this provision may be appropriate in Canada's case because of this unique provision in the existing treaty, we suggest that it will not be considered appropriate in future treaties with Canada or other countries.

The Philippine treaty completely overrides the FIRPTA provisions regarding the taxation of the disposition of an interest in a U.S. real property holding organization. I recognize that this provision was negotiated long before the enactment of FIRPTA. Further, the lack of anv anti-treaty shopping provision in the Philippine treaty could permit the abuse of the FIRPTA override by third country nationals. For these reasons I recommend that the Senate specifically reserve its consent to the Philippine treaty on this issue.

EXPANDED DEDUCTION FOR U.S. TAXPAYERS

Historically, the purposes for entering tax treaties have been the elimination of double taxation and the facilitation of administrative cooperation. Three treaties (Canada, Israel, and Jamaica) go beyond this circumscribed realm to grant to U.S. taxpayers deductions they would not enjoy in the treaty's absence. The Canadian and Israeli treaties permit U.S. taxpayers to take a deduction for contributions to a charitable orgnization in the other country. The Canadian treaty and the Jamaican protocol contain provisions permitting a U.S. person to deduct the expenses of attending a business convention in those countries.

I find these provisions particularly troubling. First, the granting of new deductions to U.S. taxpayers, even where the other country's taxpayers receive similar deductions, does not seem to be an appropriate treaty function. Particularly, as in the extension of the convention deduction to Jamaica, where Congress specified precisely which of our North American neighbors were to be included within the convention deduction rule's scope, it is inappropriate for a treaty to override Congress's specific intent. Because some Finance Committee members have expressed serious concern over this provision, I urge you to examine the Jamaican protocol with great care. Congress itself, of course, concluded that this deduction is appropriate for conventions in Canada. Had it not, the Canadian treaty provision would be similarly troublesome.

Second, there is concern whether the treaty process should be used to create support, on a selective basis, for foreign charities. While the provision in the Canadian treaty, similar to a provision in our existing treaty, may be justified by the special relationship we enjoy with that neighbor, the possibility that we could be perceived as discriminating among the charities of the world, and the effect that establishing this precedent may have on negotiations with other nations, should give us reason to question these provisions.

FOREIGN TAX CREDIT

The question of what foreign taxes are creditable against U.S. tax has, for several years now, been the subject of substantial controversy. Several versions of the section 901 regulations that have been proposed have been subjected to substantial criticism by affected taxpayers.

Some taxpayers maintain that the regulations adopt an overly restrictive interpretation of the statute so that the credit issue may be preserved for treaty negotiations. Taxpayers also complain that requests for IRS rulings receive no action and suspect similar motives to explain the IRS inaction.

I am sympathetic with the plight of taxpayers who do not know whether the foreign tax they pay is creditable or not. This issue ought to be addressed administratively, by regulation or ruling, or, if necessary, by legislation. Because the issue deals with a tax benefit to be enjoyed by U.S. taxpayers that is granted unilaterally, requiring no action by the foreign country, I believe that the granting of a credit for an otherwise clearly uncreditable foreign tax or levy is an inappropriate subject for the typical tax treaty.

Particularly where, as in the Moroccan and Israeli "forced loan" situations, the foreign levy deemed creditable against U.S. tax is quite distinct from an income, war profits, or excess profits tax (or a tax assessed in lieu of such a tax), the treaty process appears to interfere with a clear legislative decision. If it is concluded, in any instance, that the treaty process is an appropriate forum for designating a foreign levy creditable against U.S. tax, I trust, at the least, that the negotiators will recognize that the decision that a foreign levy is creditable, while a benefit to U.S. taxpayers, is a detriment to the U.S. Treasury and should be regarded as a significant U.S. concession.

DISCRIMINATION

It is unfortunate whenever a tax treaty, particularly one with a developed country, fails to resolve tax discrimination problems between the treaty partners. The dispute with Canada over C-58, Canada's indirect tax discrimination against U.S. broadcasters, is exactly the sort of dispute it was hoped the new Canadian treaty would resolve. I am disappointed that the new treaty, at the insistence of the Canadians, ignores this dispute. In weighing whether you will favorably report the Canadian treaty, we hope you will include the need for a prompt resolution of this dispute in your calculus of benefits verus detriments.

COMPETENT AUTHORITY DISCRETION

Consistent with preserving the Senate's right to advise and consent regarding tax treaty measures, your committee may wish to develop specific standards to circumscribe the power delegated to the IRS under several treaties to expand taxing jurisdiction by adjusting amounts expressed in currency and by resolving disputes outside the scope of a treaty. The Finance Committee would be happy to work with you in the development of such standards if you desire.

It is also important that Congress and the General Accounting Office not be precluded from access to mutual agreement case files in the possession of the competent authority. Your report, I understand, will make this point clear.

TAX HAVENS

The Treasury's decision to withdraw from consideration the treaties with the British Virgin Islands and with Cyprus is to be applauded. Until satisfactorily strict anti-treaty shopping provisions, similar to the one in the Jamaican protocol, are included in those treaties, their progress through the ratification process will be justifiably difficult.

In conclusion, I wish again to reiterate my thanks for your solicitation of Finance Committee views. Your attentiveness to the concerns of the Finance Committee and the cooperation your staff has shown in accommodating our efforts are essential first steps at improving the coordination of the tax treaty and the tax legislation processes. I would be pleased to have you include this letter in the record of your committee's hearing on September 24, and I look forward to working with you further on this matter.

Sincerely,

Bob Dole, *Chairman.*

Arthur Andersen & Co.,
Washington, D.C., September 23, 1981.

Hon. Charles H. Percy,
Chairman, Committee on Foreign Relations, U.S. Senate, Washington, D.C.

Dear Mr. Chairman: We are pleased to support the proposed new U.S.-Canada Income Tax Treaty and urge its approval by the Senate Foreign Relations Committee and by the full Senate. This treaty has addressed a number of important tax issues relating to both countries and to taxpayers doing business in both countries. The U.S. and Canadian treaty negotiators are to be commended for the considerable time and effort they have devoted to this treaty. It contains many needed provisions and should serve the legitimate needs and concerns of both countries for many years into the future.

We have reviewed the treaty in some detail and are attaching a list of fairly specific points where clarification or interpretation seems desirable. To the extent that these might be reflected by modification to the treaty language, we recommend such action. In the alternative, some form of interpretative release, approved by both countries, would be highly desirable.

The comments on the attached statement are presented in question and answer form. We hope they will be useful to you and others on the Committee in reviewing the treaty as a whole.

We appreciate the opportunity to present our views to your Committee on this matter and will be pleased to respond to any questions you or others on the Committee may have. Such questions may be directed to me at 862-3332, or to Max Stucker in our Chicago office (312-580-0033).

Very truly yours,

William C. Penick.

Enclosure.

United States-Canada Income Tax Treaty

ARTICLE V (PERMANENT ESTABLISHMENT)

1. *Article 5, Para. 5.*—In the case of a salesman who visits the United States a few days each year and has authority to accept orders and does so would his activities result in a PE? The correct answer we believe is "no." This might be contrasted with the situation of a salesman permanently situated in the U.S.

2. *Article 5, Para. 6(a)* refers to the use of facilities solely for the purpose of storage, display or delivery of goods. Given the circumstances of a traveling salesman of a Canadian company whose U.S. orders are submitted to a head office in Canada for approval, and whose orders are then filled by issuance of goods from storage facilities within the U.S. the conclusion appears to be that such activity would not constitute a permanent establishment. This is to be contrasted with the salesman who is working out of such facilities and who might use them also as office or showroom facilities. If we have concluded correctly above, we believe this is a correct result.

ARTICLE VI (INCOME FROM REAL PROPERTY)

1. *Article 6, Para. 3.*—We visualize some problems with the term "alienation." It is unclear whether certain deemed dispositions under Canadian law will be alienations for purposes of the treaty. Thus, if a U.S. corporation should cease to carry on an oil and gas business in Canada, it will be deemed to have disposed of the oil and gas property for Canadian income tax purposes. This income will not be covered by the convention insofar as there has been no actual alienation. We believe this is a situation that should be resolved by the new treaty to avoid the cries of double taxation. A possible solution is to allow a deemed realization for U.S. income tax purposes, similar to that provided in article 13, Para. 7 for individuals.

ARTICLE VII (BUSINESS PROFITS)

1. *Article 7, Para. 2.*—Can a branch be charged a royalty by its head office? We believe the preferred answer is "yes."

2. Are management and administration fees now to be exempt from withholding tax and dealt with under Article 7? We believe the preferred answer is "yes." The

old treaty (Article II) specifically excluded management charges from the term "industrial and commercial profits."

ARTICLE VIII (TRANSPORTATION)

1. *Article 8, Para. 3.*—Permits a state to tax profits from the voyage of a ship where the principal purpose is to transport passengers or property between places in that state. How is principal purpose to be determined? A definition such as one based on number of total miles of the voyage or destinations of total passengers would be helpful.

ARTICLE X (DIVIDENDS)

1. *Article 10, Para. 2(a).*—Reference is made to the ten percent voting stock criteria set forth in that subparagraph. Please clarify at what point the stock ownership test is to be applied, i.e., is it possible for a company to achieve a reduced rate of withholding tax by acquiring sufficient shares to meet the 10 percent voting stock test immediately before the declaration of a dividend or immediately before a payment of a dividend? The requirement of 10 percent ownership immediately prior to the declaration date would add appropriate certainty.

2. *Article 10, Para. 3.*—In the case of debt, which is recharacterized as stock under the IRC Section 385 regulations (the effective date of which has been postponed), would "interest" or principal repayments on such an instrument be covered by this paragraph? We believe the preferred answer is "yes."

3. What is the meaning of Article 10, Para. 6(d)? It would appear that the intention was to provide a permanent $500,000 (Canadian) reduction of Canadian income subject to branch tax. The working of Article 10, Para. 6(d) implies the $500,000 would be taxable in years subsequent to when it is first used. The reasonable interpretation is that the full $500,000 is allowed against aggregate net earnings (less taxes).

ARTICLE XI (INTEREST)

1. *Article 11, Para. 3(d).*—There is a reference in this subparagraph to sales made between persons dealing with each other "not at arm's length." Please clarify whether the term "dealing with each other not at arm's length" means within the particular circumstances or because of the relationship between the parties. Specifically, if a parent company and a subsidiary were dealing with each other on an arm's length basis vis a vis pricing, would this be allowable? We believe the mere fact of the relationship of parent and subsidiary should not preclude the exemption from withholding on interest on any receivables arising from sales between such parties. Canadian Act Section 251(2) states that the relationship is controlling and therefore, related parties can not deal at arm's length.

2. *Article 11, Para. 7.*—That paragraph deals with excess interest. Please clarify whether such excess will be taxed at the normal rates applicable to interest, under either the code or the Canadian Act, (without reduction under the treaty). Alternatively is the meaning of this paragraph that such interest, if deemed to be a dividend by a particular jurisdiction, taxable as a dividend under the treaty? We believe the alternative of withholding at rates applicable to a dividend is preferred.

3. *Article 11, Para. 6.*—Please confirm the following example: A U.S. corporation has a Canadian branch which incurs interest expense in Canada to a Canadian lender. U.S. income tax law (I.R.C. Section 861(a)(1)) would normally require the U.S. withholding tax on such interest. However, the above cited article would seem to exempt such interest from U.S. withholding tax. We believe the latter result is correct.

ARTICLE XII (ROYALTIES)

1. *Article 12, Para. 7.*—This paragraph suggests that excess royalties might be treated as dividends according to the laws of a particular country. In such a case the rules applicable to the dividend withholding tax should come into play under the treaty. However, an alternative view is that excess royalties would not be subject to the 10 percent withholding tax limitation was provided by Article 12, Para. 2, but rather would be subject to the applicable withholding taxes of either the U.S. or Canada, as the case may be. We believe the first view is preferred.

ARTICLE XIII (GAINS)

1. *Article 13, Para. 4.*—Apparently, in some circumstances, death will be treated as alienation. Thus, if a U.S. citizen dies while residing in the U.S. and owning shares in a Canadian company, the gain deemed to arise upon his death for Canadian income tax purposes would be exempt from Canadian tax under the treaty. However, if a U.S. citizen dies while residing in Canada and owns shares in a Canadian company, the gain deemed to arise upon his death for Canadian income tax purposes would not be exempt under the treaty. Consideration should be given to expanding this exemption under the treaty to cover the latter situation.

2. *Article 13, Para. 5.*—Consideration should be given to deferring application of this article in the case of individuals who terminated residency of the other country before the effective date of the new treaty.

3. *Article 13, Para. 6.*—The new treaty contains a special rule that increases the basis in a Canadian individual's "principal residence" in Canada to its value at the time he becomes a non-resident of Canada. The Canadian home, thereafter, may be sold under circumstances that fail to qualify in the U.S. for the tax-free "rollover" or tax-free gain from the sale of a principal residence by an individual age 55 or older. In such a case the gain is limited to appreciation in value arising after the individual becomes a U.S. resident. The Treasury's technical explanation does not clarify how flexibly the new rule will be interpreted.

A home that is classified as a principal residence under Canadian law may not be so classified under U.S. law. For example, for U.S. tax purposes, a married couple can have only one principal residence. Under Canadian law a husband and wife can each have a principal residence each of which may qualify for Canadian capital gains exemption.

A second instance would be where, under Canadian law, an individual converts a principal residence into rental property and elects to treat the property as a principal residence for four additional years. As a result, Canadian capital gain on a subsequent sale of that property is exempted by taking this four year period into account. Under the Internal Revenue Code, however, a principal residence that has been converted to rental property will likely lose its eligibility for any tax-free rollover or exemption.

We believe that in each of the above cases the individuals should be entitled, for U.S. income tax purposes, to a step up in the cost basis of their properties.

4. *Article 13, Para. 5-7.*—This article was designed to allow a taxpayer, for U.S. tax purposes, to increase his cost basis to the amount of deemed proceeds on departure from Canada. However, this would appear to be allowed in only two rather limited cases:

a. to principal residences in Canada owned and deemed disposed of by individuals other than U.S. citizens; and

b. to any property deemed disposed of by a U.S. citizen leaving Canada to return to the U.S.

The stepped-up cost base does not generally apply to Canadians moving to the U.S. We believe this creates an inequitable result particularly when contrasted with the Canadian rules. The general rule should allow for a step-up in cost basis of property for Canadians moving to the U.S.

ARTICLE XIV (INDEPENDENT PERSONAL SERVICES)

1. With regard to Article 14, can a definition of a "fixed base" regularly available to an individual performing independent personal services be provided? A definition similar to Article 5, Para. 2 would be of benefit.

ARTICLE XV (DEPENDENT PERSONAL SERVICES)

1. The term "borne by an employer" needs interpretation. Do the words "an employer" refer merely to the employment of a resident of the other state? Alternatively, does it have the general meaning of having any employees in the context of a master and servant relationship. For example, an employee of a Canadian company may visit the U.S. to perform services for a U.S. company. Under general rules he would not be an employee of the U.S. company. In such a situation, if the U.S. company is charged a fee for that individual's services, he will be subject to U.S. income tax provided the $10,000 test is not met.

We believe the individual should not be taxed based upon the action of third parties—i.e., whether or not a charge is made for his services.

2. Does Article 15 apply if the person is employed by his wholly owned personal service corporation (in other than the athlete or entertainer situation)? We believe the preferred answer is "yes."

ARTICLE XVII (WITHHOLDING OF TAXES IN RESPECT OF INDEPENDENT PERSONAL SERVICES)

1. The new treaty does not clarify how directors fees are to be treated. Under U.S. law, directors fees are treated as self-employment income that presumably would be covered under the independent personal services rule of the new treaty. However the IRS has never made clear whether a non-resident alien director is deemed to have a "fixed base" on the premises of the company where he attends board meetings. If not, then the new treaty would probably always exempt the Canadian director from U.S. tax on his director's fee. If the company's board room is treated as a fixed base regularly available to the Canadian director then presumably he would be subject to U.S. tax on such fees.

In contrast with U.S. law, Canadian law provides that directors are treated as employees rather than as self-employed

If a U.S. director of a Canadian company is treated as an employee then the new treaty would apparently exempt him from Canadian tax if his fees do not exceed $10,000 (Canadian) in the calendar year.

We believe the treaty should provide that directors are employees for both U.S. and Canadian income tax purposes and are to be covered by the dependent personal services rules.

ARTICLE XVIII (PENSIONS AND ANNUITIES)

1. *Article 18, Para. 2(a)* refers to reduced withholding tax in the case of a periodic pension payment. Article 18, Para. 3 defines "pensions" as including "any payment under a—pension—plan. . ." Does Article 18, Para. 2(a) apply to reduce withholding tax on a lump sum distribution from a pension plan? The preferred answer is that both lump sum and periodic pension payments would be subject to the 15 percent withholding tax.

ARTICLE XXII (OTHER INCOME)

1. It appears that Article 22, Para. 2 limits the tax on distributions from a trust to 15 percent even when such income would otherwise be taxed at higher rates (such as the rate which would apply to mineral resource royalties). Therefore, the treaty leaves open opportunity to abuse which should be closed, perhaps by applying tax rates based upon the underlying character of the income being distributed.

ARTICLE XXIV (ELIMINATION OF DOUBLE TAXATION)

1. *Article 24, Para. 3(b).*—If Canada taxes a gain on Canadian property owned by a U.S. resident who was formerly a Canadian resident, the treaty appears to state the income would be U.S. source. This should be recognized as foreign source income. Possibly, IRC Section 904(b) will have the final effect of treating it that way.

2. A protocol should be considered to allow U.S. corporations a foreign tax credit for the 8 percent excise tax on oil and gas production in Canada. Currently, this excise tax is not creditable for U.S. income tax purposes and the treaty makes no specific reference to it. Such a protocol would help alleviate resulting double taxation. This problem may be aggravated further since Canada is considering increasing this tax to 16 percent.

3. It would be desirable for the treaty to specify that the general Canadian corporate and individual income taxes are creditable taxes for U.S. foreign tax credit purposes.

ARTICLE XXIX (MISCELLANEOUS RULES)

1. The new treaty discusses the taxability upon distribution from a Canadian registered retirement savings plan (RRSP). The new treaty however is silent on the U.S. tax treatment of U.S. citizens resident in Canada who are participants in a Canadian Registered Pension Plan (RPP). Such a plan is generally equivalent to a U.S. qualified employee plan.

Many U.S. citizens working in Canada would be covered by a U.S. plan instead of a Canadian plan. However, U.S. citizens who are covered by Canadian plans and whose benefits are vested are generally taxable currently by the U.S. on their share of employer contributions to an RPP. Recently enacted rules on "qualified foreign plans" do not seem to alleviate this result. The new treaty should attempt to deal with this area and resolve the very difficult question of how distributions from an RPP to a U.S. citizen are taxed under U.S. law.

2. The new treaty also does not provide a U.S. tax deferral or an exemption from U.S. tax for pension contributions made by a Canadian employer for the benefit of a Canadian citizen working temporarily in the U.S. Thus, if a Canadian company makes contributions to a Canadian pension trust while the Canadian employee is working in the U.S., either as a U.S. resident or a non-resident, the contributions are generally taxable to the individual for U.S. income tax purposes if his benefits are vested. The present treaty does not otherwise exempt him from U.S. tax on this employment-type income. Tax deferral on this item can be obtained only in the unlikely event the Canadian plan satisfies the complex U.S. qualification rules. A treaty rule which would allow exemption from U.S. tax for such Canadian employer contributions would appear to be desirable.

We wish to thank the Committee for its consideration of the above comments.

Arnold & Porter,
Washington, D.C., September 28, 1981.

Hon. Charles H. Percy,
Chairman, Committee on Foreign Relations, U.S. Senate, Washington, D.C.

Re: Proposed United States/Canada Income Tax Treaty

Dear Chairman Percy: I am writing in response to the invitation which you extended at the hearing held with respect to the proposed U.S./Canada Income Tax Treaty on September 24, 1981.

1. THE PROPOSED CONVENTION SHOULD NOT BE RATIFIED AT THIS TIME

I have carefully examined the existing tax convention as well as the proposed convention, the various explanations provided by the Treasury Department and the Staff of the Joint Committee, relevant U.S. and Canadian tax laws as well as other relevant Canadian laws and policy relating to U.S. and Canada relations. Based on this analysis, I respectfully urge that the Foreign Relations Committee not take action with respect to the proposed U.S./Canada Income Tax Treaty without further and full consideration of the important tax and other issues raised in the enclosed memoranda and as described further herein. In view of the seriousness of the deficiencies in the proposed convention, I specifically recommend that the current Administration reopen negotiations with the Canadians with a view toward amending the present proposed convention.

It is worth noting that not one U.S. company or private individual testified in support of the proposed convention at the recent hearing. Only the Treasury Department appeared to support the result of its efforts over almost a ten-year period, and the Staff of the Joint Committee was at best lukewarm as to the desirability of prompt ratification. Neither the State Department nor the Commerce Department saw fit to appear to support the convention, despite the fact that this convention is probably the most important tax convention for each of the countries involved.

I have set forth in the enclosures to this letter reasons why the Committee should not give its advice and consent at this time. The balance of this letter focuses on some of the most important issues raised as well as on points made at the hearing.

2. THE REDUCTION OF TAXES IMPOSED ON DIVIDENDS IS NOT OF OVERALL BENEFIT TO THE UNITED STATES OR U.S. TAXPAYERS

An analysis of the convention and changes it makes in the existing convention discloses that the one apparent major change of benefit to the United States is the reduction in the withholding tax rate on dividends paid to affiliated companies from 15 percent to 10 percent. The supposed benefit, however, is illusory. As indicated by the Joint Committee Staff in its testimony, the provision, while reciprocal in language, in practice is not. Canadian companies with affiliates in the United States will continue to be able to withdraw dividends from their U.S. companies at a withholding rate of only 5 percent by passing those dividends through Netherlands corporations organized for that purpose. While the Treasury may hope to eliminate this route it has not yet done so and there is no assurance that it can. It is therefore obvious why the Canadians were unwilling to reduce the withholding tax rate to 5 percent, the international norm for taxes on dividends paid by affiliates.

Accordingly, even this provision, which is described as the major benefit to the United States resulting from the convention, is a significant and adverse departure from established U.S. tax treaty negotiating position of providing for a 5 percent tax rate as reflected in its model treaty and which is provided in approximately two-thirds of existing U.S. tax conventions.

The benefit of the reduction in withholding rates applicable to dividends is offset by discriminatory provisions of Canadian internal law, not affected by the proposed treaty, which gives Canadian residents a credit for a portion of the Canadian corporate tax when taxing dividends received. No such credit is given to nonresident shareholders. The Canadian integrated tax system serves effectively to reduce the corporate tax with respect to Canadian-owned companies, but not with respect to U.S.-owned companies. This is a significant discriminatory practice, and one which the United States has opposed throughout the world. Solutions to this problem have been successfully negotiated with several countries, including France, the United Kingdom, and Demark. The concession by the U.S. negotiators to continued Canadian discrimination is one reason why U.S. companies, even those with Canadian subsidiaries who would benefit from the reduced rate of withholding, have hesitated to support the convention. The reason is that there are many other countries of the world which have or which will likely adopt similar integrated tax systems. Ratification of the proposed treaty, which permits the continued discrimination by Canada through its integrated tax system, would set an inappropriate and unfortunate precedent, which would seriously impede the ability of the United States to negotiate appropriate treaties with other countries. Of particular concern are the continued negotiations with Germany, with whom the United States has been attempting to resolve this problem for the past several years. The German negotiators will undoubtedly use the Canadian treaty as a further argument for their refusal to grant appropriate relief to U.S. investors.

There are other forms of discrimination permitted with respect to taxation of dividends and corporations. U.S. companies with Canadian affiliates may reduce the tax on dividends paid by five percentage points if they agree to dispose of at least 25 percent of the interest in their affiliates to Canadian owners. In addition, certain Canadian companies owned by Canadians are entitled to a surtax exemption which reduces the corporate tax by about one-half. U.S.-owned companies are not entitled to this benefit.

Accordingly, it is clear that the dividend tax provisions acclaimed as the major benefit to U.S. companies in the treaty is non-reciprocal in practice and fraught with continued discrimination against U.S. investors. As you pointed out during the hearing, if we cannot resolve these important discrimination issues with Canada, how can we hope to convince other countries to eliminate their discriminatory practices during our tax treaty negotiations?

3. TAXATION OF NATURAL RESOURCE INCOME

Another provision of the proposed convention cited by Treasury as of significant advantage to U.S. interests is the reduction in the withholding tax rate on royalties from 15 percent to 10 percent. As pointed out, however, by Treasury in its testimony, the treaty at the same time removes natural resource royalties completely from the protection of the treaty. While Treasury explains that this will then permit Canada to tax such income at a rate of 25 percent (and the United States at 30 percent), in lieu of the 15 percent provided by the current treaty, there is nothing in the proposed convention which prohibits Canada (or the United States) from doubling or tripling that tax. In fact, Canada has, since the convention was signed, imposed an additional excise tax of 8 percent on such royalties and announced only this month that tax would be doubled to 16 percent. Numerous other provisions of its tax and other laws would discriminatorily deny deductions and grants available to Canadians to U.S. companies. Again, we have a provision which although apparently reciprocal does not operate reciprocally. This is particularly significant in view of the fact that U.S. investment in the petroleum industry in Canada is approximately ten times that of similar Canadian investment in the United States. The change made by the proposed convention is one of great significance to American companies, who, relying in good faith on the existing convention, engaged in transactions in Canada. When this was pointed out to the Treasury Department, the response was U.S. model treaty. It appears that the U.S. model treaty, at least with Canada, only served as a "buffet" of opportunities from which the Canadians could pick those provisions of benefit to them and decline others (in some cases, declaring them non-negotiable). While the royalty provision in the proposed convention may be appropriate in an initial convention with a new treaty partner when there is no existing treaty protection, it appears inappropriate to eliminate treaty protection which has been in existence for 40 years under the existing U.S./Canada convention. This is particularly critical in view of the tremendous disparity in the result of the new provision because of the lack of reciprocity resulting from the difference in investment flows in this area. As a minimum, if this treaty is to be ratified, existing agreements should be protected. To that end, I propose, as suggested by the testimony submitted by the Staff of the Joint Committee on Taxation, that a reservation be entered which would "grandfather," on a reciprocal basis, the tax treatment with respect to royalty interests created by binding agreements entered into before the date of signature of the proposed convention. A draft reservation to that effect is enclosed for your consideration.

4. PROPOSED CONVENTION PERMITS CANADA TO DENY LEGITIMATE BUSINESS DEDUCTIONS

The present treaty permits Canada and the United States to tax business operations within their countries by residents and companies of the other country but are required to allow related deductions. Canada does not allow deductions under its law for royalties or taxes paid with respect to natural resource income. These royalties and taxes often exceed 40 percent of gross income of U.S. companies operating in Canada. The proposed convention specifically provides that Canada is not required to allow a deduction for such treatment in the future. The United States allows such deductions under the provisions of the Internal Revenue Code and therefore the new language is not reciprocal in effect. No other U.S. treaty contains such language.

5. THE PROPOSED CONVENTION SHOULD NOT BE RATIFIED AT THIS TIME

There is no immediate pressing need for ratification of the proposed treaty. On the other hand, there is need to consider in a calm, deliberative fashion, all of the important tax, trade and investment issues which presently exist between the U.S. and Canada. For example, an issue arose at the hearing which had not previously surfaced involving the creditability of the Canadian corporate income tax as applied to U.S. natural resource industry investments in Canada. The Treasury Department was unable to confirm whether the Canadian corporate tax would be considered a creditable tax either under the Internal Revenue Code or under the treaty. The preamble to the proposed convention states its purpose is to prevent double taxation, yet after ten years of negotiation and a request for prompt ratification, the Treasury is unable to confirm that it does. The major reason for this indecision is that there were many significant Canadian tax and other proposals and legislation which were not disclosed until after the convention was signed. How can the Treasury Department urge the prompt ratification of the proposed convention when it is unable to quantify even in the broadest terms the net revenue effect, when it is unable to even comment on the significance of the relationship of the treaty to Canada's energy and general foreign investment policy, and when it is unable to advise U.S. taxpayers as to whether the major Canadian tax may be offset against U.S. taxes? The Treasury Department should take advantage of the fact that Canada has made such significant proposals to change the economic relationship between the United States and Canada with respect to trade and investment matters since signing the treaty to request further negotiations with Canada as well as to consult with other branches of the U.S. Government and expertise and responsibility in these areas.

To endorse the tax treaty in its present form at this time would send a clear signal to the Canadians, as well as to numerous other governments with which we shall be negotiating in the future, that we do not take the issues described in this letter and the enclosures seriously.

I urge you and the other members of the Foreign Relations Committee to consider carefully all of the issues in this letter and enclosures, and if you believe it would be helpful, to hold further hearings at which these important issues could be addressed.

Sincerely yours,

JOSEPH H. GUTTENTAG.

Enclosures.

REPORT OF THE COMMITTEE ON FOREIGN RELATIONS

The Committee on Foreign Relations, to whom was referred the Convention between the United States of America and Canada with respect to taxes on income and capital (Executive T), having considered the same, reports favorably thereon to the Senate and recommends that the Senate give its advice and consent to ratification thereof with the following reservation:

Paragraph 5 of Article XXX, at the end thereof add the following sentence: "Article XI of the 1942 Convention shall continue to apply to payments with respect to rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources, at the election of the taxpayer, if such payments are made pursuant to a binding agreement entered into prior to the date of execution of this Convention."

[Memorandum]

WHY THE SENATE SHOULD NOT GIVE ITS ADVICE AND CONSENT AT THIS TIME TO THE RATIFICATION OF THE PROPOSED UNITED STATES-CANADA TAX CONVENTION

A new income tax treaty between the United States and Canada is about to be considered by the Senate. A hearing has been scheduled before the Senate Foreign Relations Committee on September 24, 1981.

The existing tax treaty between the United States and Canada is one of substantial importance to both countries and needs to be updated. For the reasons stated below, however, we respectfully urge that the Senate not give its advice and consent to the ratification of the proposed U.S.-Canada income tax treaty at the present time and urge renegotiation of controversial issues described below by the new administration.

The proposed treaty, even though the subject of the most extensive negotiations ever conducted with respect to a U.S. tax treaty, fails to reflect an appropriate balance in the handling of tax issues.

The attached issue sheet lists several of the more important controversial issues, some of which existed during the negotiations, others of which did not arise until after the treaty was signed, but all of which should be the subject of further negotiations between the United States and Canada.

In addition to the technical tax issues involved, there are other reasons why ratification should be delayed. The major purpose of a tax treaty is to encourage trade and investment between the two countries by eliminating inappropriate tax barriers, determining an appropriate sharing of revenue, and preventing tax avoidance. The existence of a tax convention assumes the desirability and existence of trade and investment opportunities in both directions. There are presently pending before the Congress several bills designed to address problems which have arisen in this connection between the United States and Canada. While the U.S. remains open to Canadian and other foreign investment, Canada substantially restricts U.S. investment and has also announced as a matter of government policy the take over of foreign-owned natural resource interests. The pending legislation is designed to provide a more appropriate balance and should also trigger high-level discussions between the United States and Canadian governmental authorities in order to provide more reciprocal opportunities.

One set of bills pending before the Congress would eliminate the present advantage afforded Canadian companies, which desire to acquire U.S. companies, by subjecting Canadian as well as other foreign companies to margin requirements to the same extent as is imposed on U.S. companies desiring to make similar acquisitions in the United States. These bills include S. 1436, sponsored by Senators D'Amato and Kassebaum, and S. 289, sponsored by Senators Tower and Bentsen. S. 1429, sponsored By Senators Kassebaum and Johnston, would impose margin requirements and in addition require the study of acquisitions of U.S. energy enterprises by foreigners and impose a moratorium on the acquisition of U.S. energy companies by Canada. H.R. 4145, 2879 and 4033 are similar to the Senate bills.

H.R. 4186, sponsored by Representative Santini and 42 co-sponsors, would require a study of the acquisitions of U.S. mineral land leases by foreigners and impose a moratorium on certain such acquisitions.

Other legislation is being considered in reaction to the discrimination under Canadian tax law with respect to the non-deductibility of expenses for advertising on U.S. radio and television stations.

A desirable U.S. tax treaty with Canada should not be held hostage in order to secure other concessions and agreements with Canada. However, particularly since the new Canadian energy policy and other restrictions with respect to foreigners were not announced until after the treaty was signed, it is appropriate for the Senate to consider all of these matters and their relationship. It is inappropriate for the United States to enter into a tax convention with Canada which reduces U.S. taxes with respect to Canadian investors while Canadians have an advantage over American companies in acquiring such investments. Furthermore, we should not permit Canada to restrict in a discriminatory fashion U.S. acquisition of Canadian companies as well as to continue to tax earnings from permitted investments in a discriminatory manner.

The Senate should withhold its advice and consent to the proposed U.S.-Canada tax treaty until it has had an opportunity to consider all of these important issues.

ISSUES WHICH SHOULD BE CONSIDERED BEFORE RATIFICATION OF THE PROPOSED UNITED STATES-CANADA TAX TREATY

1. *Discrimination.*—Elimination of discriminatory taxation is an important purpose of our tax treaty program. The U.S. has always prided itself in not discriminating in its tax law against foreign traders and investors. The proposed Convention contains a non-discrimination provision which does not provide as broad coverage as the U.S. model treaty provision and recent U.S. treaties. The United States agreed specifically in the Convention to remove an alleged discriminatory provision of the Internal Revenue Code with respect to deductibility of convention expenses. Accordingly, conventions held in Canada will be treated in the same fashion for income tax deduction purposes as if the convention had been held in the United States and vise versa. Despite the removal of the alleged U.S. discrimination, the proposed Convention would still permit Canada to continue discriminatory practices in its tax law, such as the following:

(a) Canada discriminates against U.S. broadcasters by denying Canadian tax deductions for advertising on U.S. stations.

(b) Canada discriminates against U.S. lenders of funds to Canadian borrowers.

(c) Canada discriminates against foreign natural resource companies. As part of its system for taxing natural resource operations, Canada provides certain incentives which are only available to natural recource companies principally owned by Canadians. This further discrimination was announced just one month after the signing of the proposed Convention.

(d) Canada discriminates against U.S.-owned businesses by taxing dividends at a rate five percentage points higher than with respect to U.S. companies with a substantial Canadian ownership, and by not affording a surtax exemption to U.S.-owned Canadian companies.

The Canadian treaty will be considered as a precedent by other countries with which the U.S. will be negotiating tax treaties and will make it even more difficult to eliminate discriminatory taxation in future negotiations.

2. *Natural Resource Income.*—The present treaty restricts taxes by both countries on royalty income to 15 percent. The proposed treaty eliminates all restrictions on royalty income from natural resource operations. According to the technical explanation of the proposed treaty published by the U.S. Treaty Department, the United States was advised that Canada might enact a "low flat rate tax on resource revenues." Shortly after signing of the proposed treaty, Canada enacted an 8 percent production tax which the U.S. Treasury confirmed was "consistent with the understandings reached during the negotiations."

On September 1, 1981, Canada announced that it was doubling the production tax to 16 percent. There is nothing in the proposed treaty which prohibits Canada from redoubling the tax, since the proposed treaty does not extend in this respect to any taxes which Canada labels an excise tax as opposed to an income tax.

3. *Taxation of U.S. Companies Operating in Canada.*—The present treaty permits Canada and the United States to tax business operations within their countries by residents and companies of the other country but are required to allow related deductions. Canada does not allow deductions under its law for royalties or taxes paid with respect to natural resource income. These royalties and taxes often exceed 40 percent of gross income of U.S. companies operating in Canada. The proposed Convention specifically provides that Canada is not required to allow a deduction for such royalties and taxes, thereby legitimatizing such treatment in the future. The United States allows such deductions under the provision of the Internal Revenue Code and therefore the new language is not reciprocal in effect. No other U.S. treaty contains such language.

4. *The Proposed Treaty Discriminates Against U.S. Investors in Canadian Companies by Failing to Extend the Benefits of the Canadian Integrated Tax System to Such Investors.*—Under the Canadian domestic tax law, Canadian residents are entitled to certain benefits with respect to dividends from Canadian companies under Canada's integrated corporate tax system. A problem with a similar regime under the United Kingdom tax system was resolved satisfactorily in the new U.S.-U.K. tax treaty by extending benefits of the U.K. system to U.S. investors. Many other important foreign countries have similar systems, including Germany, U.K., France and Denmark. Progress has been made to some extent in existing or proposed treaties, but negotiations with several important foreign countries such as Germany are presently stalemated. Ratification of the Canadian proposed treaty in its present form will send a clear signal to German negotiators that the United States is willing to permit continuation of this discrimination and will severely impede, if not block, execution of appropriate treaties with Germany and other countries.

National Foreign Trade Council, Inc.,
New York, N.Y., September 23, 1981.

Hon. Charles H. Percy,
Chairman, Committee on Foreign Relations, U.S. Senate, Washington, D.C.

Dear Mr. Chairman: The National Foreign Trade Council, a private, nonprofit business organization of more than 650 companies engaged in foreign trade and investment, welcomes the opportunity to present its views with respect to the several income tax treaties which are being considered by the Committee.

Our membership has long supported the tax treaty programs and has urged the Treasury Department and the Congress to provide more expeditious consideration of treaties that are submitted for ratification. It is regrettable, however, that, although some of the treaties have been awaiting ratification for several years, 14 are called up for a hearing at once. We hope that in the future, tax treaties will be negotiated and considered for ratification at reasonable intervals, allowing for deliberate consideration and comment by business interests.

In general, the Council recommends that all treaties should contain provisions to offset the discriminatory effect against foreign investment which occurs in countries which have enacted legislation integrating corportate and shareholder taxation. Among those treaties, being considered today, the Canada-U.S. Income Tax Treaty, for example, is discriminatory in that it fails to take into account Canada's integrated corporation tax structure.

A number of countries now provide relief from double taxation through partially integrated tax systems under which the tax burden on distributed corporate profits is lightened.

Canada employs a modified imputation system. Corporations pay tax on their income at the appropriate corporate rate whether or not it is distributed to shareholders. Dividends received by individuals and trusts resident in Canada are grossed-up by a factor of 50 percent, and the gross amount is included in the shareholder's income. A credit against tax otherwise payable approximately equal to the gross-up is allowed to the shareholder. The credit is available regardless of the amount of corporation taxes paid by the company. Should the credit be greater than the amount of tax otherwise payable by the shareholder, the excess is not refundable. This gross-up and credit system may, in some cases, enable a shareholder to receive dividends without attracting any personal income tax.

Such a shareholder credit system is discriminatory against foreign investors in that the effective tax on dividends paid to non-resident shareholders is greater than the tax on dividends paid to Canadian resident shareholders.

The Council further recommends that all tax treaties should incorporate the non-discrimination article of the proposed U.S. Treasury Department model tax treaty and the model double taxation convention of the Organization for Economic Cooperation and Development. Such non-discrimination treaty provisions prohibit a country from imposing more burdensome taxes on citizens of the other state than on its own and thus help to assure equal or "national treatment" for foreign citizens.

We wish to assure this Committee of our desire to cooperate in whatever way we can in the task of developing recommendations regarding tax treaties. We would also respectfully ask for the opportunity to comment on tax treaties to be negotiated in the future.

Yours very truly,

Richard W. Roberts, *President.*

National Hockey League Players' Association,
Toronto, Canada, September 16, 1981.

Re: United States/Canada Income Tax Convention

Senator Charles H. Percy,
Chairman, Senate Foreign Relations Committee, U.S. Senate, Washington, D.C.

Dear Senator Percy: In lieu of requesting the privilege of presenting public testimony at the hearings to be held on September 24, 1981, with respect to the United States/Canada Income Tax Convention (the Proposed Tax Treaty), the National Hockey League Players' Association (the Association) desires, through this letter, to bring to the attention of your Committee certain matters arising in connection with the Proposed Tax Treaty. The Association respectfully requests that this letter be made a part of the record of the Committee's proceedings.

The Association is the collective bargaining agent for those professional hockey players who play for the twenty-one member clubs that comprise the National Hockey League (the League). Member clubs are situated in both Canada and the

United States. The vast majority of these hockey players are residents, for tax purposes, of either Canada or the United States. The Association, through its tax counsel, studies tax issues of general interest to the players, and informs them of tax developments of general concern. The Association does not however, make any recommendations to a particular player with respect to his personal tax situation. Individual tax planning is the responsibility of each individual player and his personal advisors.

Two provisions of the Proposed Tax Treaty are of general importance to the players: (1) Article XXIX [4], which provides that income from personal services (which was exempt from United States tax under the 1942 Tax Convention) shall not be considered wages or self-employment income for social security tax purposes; and (2) Article XVI [3], which, in effect, will exempt from income tax in the other State wages paid a player who is employed by a League club which is a resident of the same State as the player. Both of these provisions benefit the players generally. Because we understand that the League, through its special tax counsel, was consulted with respect to both of these provisions, the Association offers no comment, but does desire to indicate its support of them.

The Association, however, has one area of concern with the Proposed Tax Treaty. The Association believes that the language of the Proposed Tax Treaty removes, apparently inadvertently, the predictability of the tax treatment of signing bonuses paid by the League clubs. This change adversely affects the tax posture of a significant number of players in a rather unfair way.

It is not unusual for a hockey player to be awarded a bonus for signing a contract to play professional hockey. Typically, a signing bonus is paid to a rookie player who has been selected through the amateur draft. The Internal Revenue Service reviewed signing bonuses (for international soccer) in Revenue Ruling 74-108, 1974-1 C. B. 248. That ruling states that the signing bonus there involved was, in essence payment for a covenant not to compete with the team with whom the player agreed to play and was not compensation for professional services. It has long been the position of the League and of the Association that signing bonuses are payments for surrendering amateur status and are not associated with the hockey playing services to be performed under the Standard Players' Contract.

Nevertheless, subsequent to the issuance of Revenue Ruling 74-108, the Internal Revenue Service took the position that signing bonuses paid rookie hockey players constituted income effectively connected to the earnings arising from playing hockey and were taxable, to the extent attributable to United States sources, at graduated tax rates. The issue was contested in *Jerry Badiuk* v. *Commissioner*, United States Tax Court, Docket No. 10781-77. Ultimately, that litigation was settled in a stipulated decision which indicated concurrence by the Internal Revenue Service in the conclusion that a signing bonus constituted unearned income within the meaning of Article XI [1] of the 1942 Tax Convention. The Internal Revenue Service agreed that signing bonuses, to the extent attributable to United States sources, were taxable at the reduced Treaty rate of 15 percent. To the best of our knowledge, since the Internal Revenue Service's concession of the *Badiuk* case, hockey players receiving signing bonuses have, for United States tax purposes, universally enjoyed treatment of those bonuses under Article XI [1] of the 1942 Tax Convention.

Article XI of the 1942 Tax Convention has no counterpart in the Proposed Tax Treaty. Rather, the various items of unearned income are hereafter to be treated separately in provisions such as Article X and XI of the Proposed Tax Treaty (relating, respectively, to dividends and interest). The "catch-all" phrase ("other than earned income") present in Article XI [1] of the 1942 Tax Convention, does not appear in the Proposed Tax Treaty. This omission—which we believe to be an oversight—might unjustifiably bring into controversy once again the issue of the proper tax treatment of signing bonuses.

Our United States tax counsel, Messrs. Csaplar & Bok of Boston, Massachusetts, have brought this matter both to our attention and to the attention of United States Treasury Department officials. Subsequent to their December 1980 meeting with the Treasury officials, our tax counsel was informed that their comments had been reviewed and that draft language correcting the oversight had been prepared and would be embodied in a Protocol to the Proposed Tax Treaty. This language would resolve the signing bonus problem by preserving the present 15 percent tax on amounts, not treated as wages, paid as an inducement to sign a professional sports contract.

The draft language of the Protocol has not been made available to us. We have been informed that the Protocol will not be before your Committee or available to the public prior to the September 24th hearings. Since we are not certain that the Protocol will ever be entered into, or that it will emerge in the form which is essential to individual players, we submit this statement to the Committee to advise the members of the existence of the situation and of our views. The clarification which we have sought, and which we anticipate will be contained in the Protocol, is designed to preserve the status quo by continuing the income tax treatment which was available under the 1942 Tax Convention with respect to signing bonuses.

If the Committee has questions with respect to the contents of this letter, or desires further information concerning signing bonuses, please do not hesitate to call upon us or upon our tax counsel.

Sincerely yours,

R. Alan Eagleson, Q.C.,
Executive Director, National Hockey League Players' Association.

Berliner & Maloney,
Washington, D.C., September 29, 1981.

Re: Pending U.S. Tax Treaties

Hon. Charles H. Percy,
Chairman, Senate Foreign Relations Committee, Dirksen Building 4223, Washington, D.C.

Dear Senator Percy: Pursuant to your request for comments by interested persons during the hearings on September 24, 1981, on the proposed U.S. tax treaties, this letter expresses my concern over the need for further guidance by officials of the U.S. Government, responsible for negotiating tax treaties with developing countries, particularly on the issue of tax sparing.

As you know, the United States Senate has the duty to provide advice and consent to the Treasury on tax treaty policy. Many developing countries have as one of their main goals in treaty negotiation the obtention of tax sparing or investment credit provisions. Although the Eisenhower Administration in 1957 and 1958 proposed the insertion, where desired by developing countries, of tax sparing provisions in treaties, these provisions were not approved when the U.S. Senate considered various tax treaties containing tax sparing provisions. Subsequently, during the Kennedy Administration, the policy to give tax sparing provisions to developing countries was rescinded.

The Treasury Department has not received any guidance from the Senate since the early 1960's on the issue of tax sparing. It would appear that the Reagan Administration's policies support the use of tax sparing provisions since, by analogy, the Economic Recovery Tax Act of 1980 uses tax incentives as a principal vehicle to stimulate investment. In addition, hearings before the Inter-American Subcommittee on July 28, 1981, set forth testimony by Administration spokesmen on the Administration's Caribbean Basin Policy. They stated that one of the two principal goals of the Administration's Caribbean Basin Policy is to promote private investment in the Caribbean. Therefore, it would seem that, to maintain the longstanding policy of neutrality in taxing investment abroad and in the United States, and in order to promote investment in developing countries, the U.S. Senate may want to provide guidance to U.S. negotiators as to tax sparing policies.

Although the United States has a model income tax treaty, Treasury representatives have stated that there are substantial departures from the model when negotiations are held with developing countries. However, since the U.S. Treasury has not promulgated a model for negotiating tax treaties, with developing countries and since there are no official policy statements, your committee may also want to consider what, if any, guidance should be given in this area.

If I can provide you any additional information on these questions, please do not hesitate to contact me.

Sincerely,

Bruce Zagaris.

United States Senate,
Washington, D.C., October 26, 1981.

Hon. Charles Percy,

Hon. Charles Mathias.
Committee on Foreign Relations, 4229 Dirksen Senate Office Building, Washington, D.C.

Dear Chuck and Mac: Thank you very much for soliciting the comments of members of the Senate Finance Committee on the tax treaties pending before the

Committee on Foreign Relations. Your consideration of our views is greatly appreciated.

At the outset, I'd like to support the views stated in the letter to you from Senator Dole. He has eloquently expressed many of my concerns.

There are two issues of particular concern to me: first, the apparent override in many of the treaties of the Foreign Investment in Real Property Tax Act (FIRPTA); second, the failure to authorize the General Accounting Office's access to information received under the treaties.

As a member of the House, I was actively involved in the passage of FIRPTA. Adherence to the provisions of FIRPTA is a very important issue to me and the 2.8 million Iowans I represent. Our intention in enacting FIRPTA was to treat the capital gains recognition of foreigners and United States citizens similarly. In passing that legislation, Congress expected our treaty negotiations to honor the provisions of FIRPTA in new tax treaties. Technical changes negotiated in the Canadian, Argentine, Egyptian and Philippine treaties run contrary to that intent. These are serious precedents which undermine the spirit of FIRPTA. While Canada and the United States enjoy a special relationship, this does not seem a compelling reason to ignore all of the guidance set forth in the legislation. With respect to other treaties, I can see no reason at all to deviate from FIRPTA. I believe the treaties should be made consistent with FIRPTA, and I strongly recommend you report these out with a reservation that the treaties conform to FIRPTA.

My second difficulty with these treaties is their failure to expressly state that the appropriate Congressional committees, and the General Accounting Office, as their agent, have appropriate access to information exchanged under the treaties. As you are aware, the IRS has taken the position that the secrecy clause in most existing treaties denies GAO access to mutual agreement casefiles. Treasury has indicated that future treaties would specifically provide for GAO access, but most of the treaties before your committee would not do so. I respectfully request that you take whatever steps are necessary to insure that we do have access to tax information exchanged under these treaties within the boundaries of Internal Revenue Code Section 6103. As Chairman of the Subcommittee on Oversight of the Internal Revenue Service, I believe that the inclusion of this provision is very important if Congress is to effectively oversee the administration of the treaties.

Thank you for your consideration of my concerns and suggestions.

Sincerely,

CHARLES E. GRASSLEY,
United States Senator.

UNITED STATES SENATE,
COMMITTEE ON FOREIGN RELATIONS,
Washington, D.C., October 13, 1981.

Hon. JOHN CHAPOTON,
Assistant Secretary of the Treasury for Tax Policy, Department of the Treasury, Washington, D.C.

DEAR MR. CHAPOTON: Thank you for your helpful and extensive statements submitted to the Committee concerning the tax treaties which are presently pending before the Committee. There is one matter not covered in any of the pending treaties upon which I would welcome your views.

I refer to the practice of "tax sparing" by which a home country permits its companies to claim a tax credit for taxes which would normally be charged by the host developing country on the foreign companies' investment income, but have been waived in order to attract the investment. I understand that a number of developed countries provide "tax sparing" in their treaties with developing countries.

What countries provide "tax sparing", and to what extent? What is the Administration's position toward the inclusion of "tax sparing" provisions in bilateral tax treaties with developing countries?

I would appreciate receiving your reply before the Committee's meeting on October 27th at which several of the pending tax treaties will be considered. I thank you in advance for your cooperation.

Sincerely,

CHARLES McC. MATHIAS, Jr.,
U.S. Senator.

Department of the Treasury,
Washington, D.C., October 26, 1981.

Hon. Charles McC. Mathias, Jr.,
Committee on Foreign Relations,
U.S. Senate, Washington, D.C.

Dear Senator Mathias: Thank you for your letter of October 13, 1981 concerning U.S. tax treaty policies toward developing countries.

You have raised the question of whether our tax treaties with developing countries should include a tax sparing credit. This is a very complex issue, having both tax policy and political ramifications. We intend to initiate a detailed study of this issue in the very near future. As a part of that process we will consult with representatives of interested Congressional Committees.

As you are probably aware, members of my staff have begun what we expect will be a continuing process of consultations with staff members of the Foreign Relations Committee and the tax writing committees on tax treaty issues. The question of developing country tax treaty policies is already on the agenda of that group.

I am not in a position at the present time to provide an answer to your question, but I will be pleased to advise you of our position after we have concluded our study.

I would like to thank you again for providing me the opportunity to present the Administration's views on the tax treaties currently pending before the Foreign Relations Committee.

Sincerely,

John E. Chapoton,
Assistant Secretary (Tax Policy).

Department of State,
Washington, D.C., November 25, 1981.

Hon. Charles H. Percy,
Chairman, Committee on Foreign Relations, U.S. Senate.

Dear Mr. Chairman: Our support for the ratification of the United States-Jamaica bilateral tax treaty is undiminished since Walter Stoessel wrote to you on behalf of the Department.

We believe that the treaty will provide substantial benefits to the United States. For Jamaica, giving a boost to tourism through the provision in the Protocol on convention expenses is more important than ever; a recent decline in bauxite production of over 3 million tons has impaired Jamaica's prospects for earning foreign exchange. It is our understanding, moreover, that the revenue loss to the United States from this provision of the Protocol would be negligible.

If ratifications can be exchanged before the end of December, the treaty will go into effect as of January 1, 1982. Otherwise, its operation will be delayed at least a year. We would, accordingly, very much appreciate your support for rapid action by the Committee and the Senate.

Yours sincerely,

Richard Fairbanks,
Assistant Secretary for Congressional Relations.

Enclosure: Letter from Acting Secretary Stoessel.

Department of State,
Washington, D.C., September 22, 1981.

Hon. Charles H. Percy,
Chairman, Committee on Foreign Relations, United States Senate.

Dear Mr. Chairman: The Senate Foreign Relations Committee is scheduled to consider the U.S.-Jamaica bilateral tax treaty and a protocol to that treaty at hearings on Thursday, September 24.

The treaty, which was signed in May 1980, is a model for the kind of balanced tax relationships we wish to establish with less developed countries. The treaty will ensure that American citizens and firms in Jamaica do not suffer from discriminatory tax treatment or double taxation. It will reduce the withholding taxes on dividends, interest and royalties U.S. investors receive from investments in Jamaica. The treaty will improve the ability of the Internal Revenue Service to administer tax law by affording access to Jamaican financial information.

The protocol further strengthens certain provisions of the treaty. Its treatment of convention expenses is of major import to Jamaican tourism, the second largest source of foreign exchange earnings and a major employer. The government of Prime Minister Seaga views this provision as particularly significant. This Administration is committed to assisting the Prime Minister in his efforts to promote Jamaica's economic recovery and views this as a step in that direction.

The tourist industry is sagging and, as the U.S. Business Committee on Jamaica, chaired by David Rockefeller, noted during its recent meeting here, the convention tax benefits offer a means of providing this industry a quick boost. Tourism can play a major role in leading Jamaica out of its continuing economic depression.

We have in this treaty an opportunity to signal, not just Jamaica but the entire region, our determination to draw the private sector into the development process.

Your cooperation in working for early Senate passage of treaty and protocol would be greatly appreciated.

Sincerely,

WALTER J. STOESSEL, Jr., *Acting Secretary.*

AMERICAN PRESIDENT LINES, LTD.,
Oakland, Calif., October 15, 1981.

Senator CHARLES PERCY,
Chairman, Committee on Foreign Relations,
U.S. Senate, Washington, D.C.

DEAR SENATOR PERCY: American President Lines is a U.S. flag shipping company operating 17 containerships and 5 breakbulk vessels in the Pacific basin and Indian Ocean. Trade between the United States and the Philippines provides a major source of APL's cargo. We have served the Philippine trade continuously for over 60 years.

As you know, a new tax treaty with the Philippines is presently awaiting action by the Senate Foreign Relations Committee. APL is on record as supporting ratification of this treaty as soon as possible. We are, however, concerned with our coverage under Article 11 (6). We interpret the Article as providing an exemption of U.S. shipping companies from the Philippines branch remittance tax. The Treasury Department and the Joint Committee on Taxation concur in this interpretation. Yet the language is not as precise as it could be. We feel it would be advantageous to all parties concerned to clarify the meaning of Article 11 in the Senate Report. The best approach would be to have the Treasury Department, the party who negotiated the treaty, clarify this language. Enclosed please find a draft letter to the Treasury Department seeking such a clarification.

Sincerely,

C. GORDON CUDNEY,
Director of Taxes.

APL's POSITION

American President Lines (APL) is a U.S. flag shipping company operating 17 containerships and 5 breakbulk vessels in the Pacific basin and Indian Ocean. Bangladesh is within its area of operations; APL carries, from time to time, Bangladesh cargo.

APL has reviewed the proposed Tax Convention with Bangladesh. While APL recognizes and appreciates the revenue needs of less developed countries, it cannot support ratification of the Convention in its present form.

The Convention does not contain the traditional exemption for shipping income. Normally, if such an exemption is not provided for, a decrease in the rate of taxation is insisted upon by the United States. Such is the case with the Philippines Tax Convention, for example, which provides for a 40 percent reduction in source base income tax rate on shipping. APL, however, could support ratification of the Convention even in lieu of such an exemption if a most favored nation provision was contained in the Convention.

A most favored nation clause is a standard part of United States tax treaties. The reasons for this are obvious; without such a provision, United States shipping operators will face a competitive disadvantage if the other country (i.e. Bangladesh) negotiates a more favorable tax convention with another maritime nation. The failure to negotiate a most favored nation clause in the Bangladesh Convention could well become an adverse precedent in future tax convention negotiations with other less-developed nations. These nations are likely to use the Bangladesh Tax Convention as a starting point and model with which to conduct negotiations with the United States; indeed, the Bangladesh treaty contains provisions that were excerpted from previous treaties with other less-developed countries. The United States maritime industry is especially concerned with this fact since the United States shipping industry must compete against foreign competitors whose governments have been more successful than the United States in negotiating treaties with less-developed nations.

The Administration is apparently relying on the good faith of the government of Bangladesh not to enter into a more favorable arrangement with another country concerning taxation of shipping. John Chapoton, Assistant Secretary of the Treasury (Tax Policy), testifying before the Senate Committee on Foreign Relations on September 24, 1981, stated: "United States shipping operations are not placed at a competitive disadvantage with respect to shipping operators conducted by residents of other countries. Since Bangladesh will not agree to a reduction in tax at source in treaty negotiations with other countries, a competitive disadvantage is not created." There is not, however, a written, binding agreement to this effect.

APL believes that the proposed Convention should contain either a most favored nation provision or an expressed written agreement, perhaps in the form of a protocol. United States shipping operators should not have to rely on an oral agreement between the Administration and Bangladesh concerning this point. While APL is not questioning the government of Bangladesh's good faith, it is incumbent upon APL, the shipping industry, and the Senate to realize that Bangladesh lies in an area of the world where extensive government reorganization has occurred with extreme rapidity. If such a problem should confront Bangladesh, it is not inconceivable that a more favorable treaty would be granted to another maritime nation, greatly damaging United States shipping interest without abrogating the Convention. In such a case, the United States would most certainly seek to renegotiate the Convention. However, it is now within the power of the Senate to obviate the need for such a lengthy and delicate renegotiation period. The Senate should not ratify the Bangladesh Convention unless and until the Executive Branch obtains either a protocol or language within the convention itself guaranteeing United States shipping operators most favored nation status. Senate action to the contrary would leave American shipping companies in a decreasingly weakened competitive position throughout the world.

It must be emphasized that other less-developed nations will use this Convention as a model in negotiating with the United States. The Senate should view the Convention in this context and ensure that the Convention not only contain a most favored clause, but, perhaps more inportantly, that the Convention act as a strong and positive example of a United States tax treaty with a less-developed country.

SHUTTS & BOWEN,
Miami, Fla., September 30, 1981.

Senator CHARLES H. PERCY,
Chairman, Committee on Foreign Relations, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: At the recent hearings on proposed tax treaties and protocols, you invited interested persons to present written comments on tax treaty issues to the Committee for its consideration. I am an attorney in private practice and co-author of a four-volume text, two volumes of which deal with U.S. income tax treaties. I am also an Adjunct Professor of Law at the University of Miami where I teach a course on income tax treaties.

I urge the prompt ratification of all of the tax treaties and protocols considered by the Committee at the September 24, 1981 hearings. On balance they all represent an improvement over the present situation.

The large attendance at the September 24 hearings demonstrates the fact that there is substantial interest in tax treaties. My testimony before the House Ways and Means Oversight Subcommittee at hearings held in 1979 and 1980 cited IRS and Treasury statistics to show that approximately 90 percent of all foreign investment in the United States comes from (or through) tax treaty jurisdictions. The dollar volume is substantial and the issues involved in these treaties are significant.

I applaud the prompt consideration of these tax treaties by the Committee. Nevertheless, I find it distressing that this prompt action was due more to the urging of the Canadian Ambassador than by the needs of the United States Government, our businesses and our taxpayers to have these treaties in place. Tax treaties should not be treated as a step-child. The Foreign Relations Committee used to have a Subcommittee on Tax Treaties. With the significant growth of our tax treaties program I urge the Committee to reinstitute that subcommittee.

Such a subcommittee should focus on the numerous tax treaty issues raised in the excellent explanations of the pending treaties prepared by the staff of the Joint Committee on Taxation. It should also hold hearings on the 1977 and proposed 1981 U.S. model income tax treaties and explore the reasons why the U.S. model deviates from the OECD and UN models.

The Senate should do more than consent to the ratification of those tax treaties and protocols signed from time to time by the Treasury Department. The Senate should also give the Treasury *advice* on how to handle the multitude of issues raised by these tax treaties. This advice should probably include prodding the Treasury Department to renegotiate and/or terminate some of the antiquated tax treaties that no longer conform in any way to our current policies. As you, Mr. Chairman, pointed out during the hearing on the Canadian treaty, this advice should also include telling the Treasury Department the extent to which your Committee expects the Treasury to consider economic issues rather than purely technical tax issues in negotiating new treaties and protocols.

One issue that should be considered is the extent, if any, to which "treaty shopping" should be permitted. I am not convinced that all treaty shopping is bad. A foreign person from one treaty country should probably be permitted to use another tax treaty offering comparable benefits. Moreover, U.S. multinational companies regularly use treaty shopping to avoid having excess foreign tax credits.

The existence of a Subcommittee on Tax Treaties would permit new tax treaties and protocols to receive prompt attention after they are signed and sent to the Senate. It makes little sense for them to pile up until 14 treaties have to be considered at one time.

Thank you, Mr. Chairman, for the opportunity of presenting these views.

Very truly yours,

MARSHALL J. LANGER.

UNITED STATES SENATE,
COMMITTEE ON FOREIGN RELATIONS,
Washington, D.C., December 15, 1981.

Hon. DONALD T. REGAN,
Secretary of the Treasury, Washington, D.C.

DEAR MR. SECRETARY: The Committee on Foreign Relations is in the process of acting upon a series of bilateral tax treaties negotiated by the Treasury Department. Assistant Secretary for Tax Policy, John Chapoton, testified before the Committee on September 24, in support of eleven of these treaties: the income tax treaties with Argentina, Bangladesh, Canada, Egypt, Israel, Jamaica, Malta, Morocco, Norway, and the Philippines, and an estate and gift tax treaty with West Germany. The large number of these agreements, as well as some of the provisions contained in them, raise important questions about the future scope and direction of the U.S. tax treaty program.

In response to inquiries from Senators Percy and Mathias, the Chairmen of both tax-writing committees of the Congress, Senator Dole and Representative Rostenkowski, as well as the Ranking Minority Member of the Ways and Means Committee, Representative Conable, raised a number of concerns about the tax treaty process. Those letters and accompanying statements have previously been made available to your staff and will appear in the Committee's published hearing record for September 24. They indicated serious reservations about the process by which tax treaty negotiations are initiated and carried forward, as well as questions about the rationale for certain treaties and provisions.

The Foreign Relations Committee and the Senate have been considering the current group of treaties and hope to have approved most of them by the end of the year. We have been dealing with the issues raised about particular provisions of these treaties in close consultation with the leadership of the tax-writing committees. However, we think it is also important to establish certain broader understandings with your department on behalf of the Administration as a whole regarding the future of the tax treaty process. We would like, therefore, to have your assurances or clarifications on the following points.

First, we would like your staff regularly to brief the appropriate staff members of the Senate Foreign Relations and Finance Committees, the House Ways and Means Committee, and the Joint Committee on Taxation with respect to negotiations currently underway or prospective. These briefings would include a clear statement of your objectives and priorities for future treaties, as well as an indication of any significant provisions which you anticipate may arise in these negotiations which might modify existing tax statutes. In particular, we would like future briefings to occur before you begin negotiations with a country where the U.S. has had no prior tax treaty relationship in order to explain your reasons for seeking such a treaty and outlining any provisions of the proposed treaty which may depart from the usual treatment.

Second, we would like to explore with you whether it may be desirable to develop guidelines for tax treaties with developing countries which could provide a frame of reference for future negotiations with developing countries. Agreement on such guidelines would simplify Senate consideration of any future treaties of this kind. The guidelines need not be published or otherwise given the same status accorded to the U.N. or OECD model treaties if the Administration thinks that this will limit it in its negotiations.

Third, we request that revenue impact estimates for each proposed treaty accompany the formal letter of submission to the Senate. We recognize that such estimates may often be difficult and highly speculative, but the Senate should have the benefit of a general estimate of revenue impacts made by those most familiar with the facts and considerations involved in each case.

Fourth, with respect to the now-standard treaty provision giving the "competent authorities" of each country the right to arrive at mutual agreements on matters not otherwise resolved by treaty provisions, we would like a clarification of the scope of such provisions. In particular, we would like an indication as to the limits of the authority implied by such provision.

Finally, we ask that you seek an understanding in all future treaties as well as existing treaties, on the matter of Congressional access to the tax information exchanged under these treaties, such that access will be accorded to the appropriate Congressional oversight committees and the General Accounting Office, as may be necessary to fulfill their responsibilities, consistent with the procedures and limitations otherwise contained in the Internal Revenue Code. We have been adding an understanding to that effect on each of the treaties approved by the Committee.

Discussion between our respective staffs would suggest that these points will not be difficult to resolve satisfactorily. Our interest is in achieving a closer coordination and integration of the tax treaty process and the legislative process without impeding the legitimate objectives of a treaty network. We know that you generally share this objective and we look forward to working with you to insure this outcome.

Sincerely,

CHARLES H. PERCY,
Chairman.
CHARLES McC. MATHIAS, Jr.,
Chairman, Subcommittee on International Economic Policy.
CLAIBORNE PELL,
Ranking Minority Member.
CHRISTOPHER J. DODD,
Ranking Minority Member.

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